No. 15457

# In the United States Court of Appeals for the Ninth Circuit

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

*v.*

INSURANCE SECURITIES INCORPORATED, TRUST FUND SPONSORED BY INSURANCE SECURITIES INCORPORATED, ABE P. LEACH, OSSIAN E. CARR, ARTHUR J. LONERGAN, ROY A. HAIGHT, AND LELAND M. KAISER AS ATTORNEY AND PROXY FOR INVESTORS OF TRUST FUND, APPELLEES

## BRIEF OF SECURITIES AND EXCHANGE COMMISSION, APPELLANT


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# In the United States Court of Appeals for the Ninth Circuit

No. 15457

Securities and Exchange Commission, appellant

*v.*

Insurance Securities Incorporated, Trust Fund Sponsored by Insurance Securities Incorporated, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, Roy A. Haight, and Leland M. Kaiser as Attorney and Proxy for Investors of Trust Fund, appellees

## BRIEF OF SECURITIES AND EXCHANGE COMMISSION, APPELLANT

### JURISDICTIONAL STATEMENT

The Securities and Exchange Commission ("the Commission"), appellant herein, filed its amended complaint in the United States District Court for the Northern District of California, Southern Division, pursuant to Sections 36, 42 (e) and 44 of the Investment Company Act of 1940 ("the Act"), 15 U. S. C. 80a–35, 41 (e) and 43 (R. 3–48). Appellees, defendants below, filed a motion to dismiss the amended complaint for failure to state a cause of action, and in support thereof filed nine affidavits (R. 52–88). The Commission opposed the motion and filed counter-affidavits (R. 97–140). On December 4, 1956, the

District Court dismissed the amended complaint (R. 151–152).

The Commission filed its notice of appeal on January 24, 1957, pursuant to Rule 73 (a) of the Federal Rules of Civil Procedure (R. 152–153). The jurisdiction of this Court is invoked under Section 44 of the Act, 15 U. S. C. 80a–43, and 28 U. S. C. 1291 and 1294 (1).

## STATUTE AND RULE INVOLVED

The pertinent provisions of the Investment Company Act of 1940 and of Regulation X–14 are set forth in Appendix A, pp. 1a–16a, *infra*.

The Commission is charged with the responsibility of administering and enforcing the Investment Company Act of 1940. This statute was enacted by the Congress after an extensive investigation by the Commission into the structure, operation and management of investment companies. The Commission's investigation was made pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79dd).

The Investment Company Act provides for comprehensive regulation of investment companies. It applies to all types and classifications of investment companies, as indicated in Sections 4 and 5. Subjects to certain exemptions and exceptions, investment companies must register with the Commission pursuant to Section 8 (a). Section 9 (a) makes certain persons (including companies) ineligible to serve as directors, officers, investment advisers or principal underwriters. Section 10 regulates affiliations of di-

rectors, and imposes limitations and prohibitions upon transactions with the investment company when certain affiliations exist (pp. 37–39, *infra*). Section 17 regulates certain transactions between registered investment companies and their affiliates and principal underwriters. Section 18 includes provisions relating to the capital structure of investment companies, asset coverage for senior securities, and protective provisions for public investors.

Section 15 (a) requires that the investment advisory contract must be approved initially by a vote of the investors or their board of directors. A vote is also required for the annual renewal of the contract. The contract is non-assignable and is automatically terminated upon assignment by the investment adviser. Section 15 (b) contains substantially similar provisions with respect to the principal underwriting contract. Section 36 provides for the judicial removal of an investment adviser or principal underwriter where, in an action by the Commission, it is determined that such investment adviser or principal underwriter is guilty of "gross misconduct or gross abuse of trust" in respect of the registered investment company.

## STATEMENT OF THE CASE

### The Trust Fund and its management

The Trust Fund Sponsored by Insurance Securities Incorporated ("Trust Fund") was organized under California law pursuant to a Trust Agreement dated July 1, 1938. Its principal office is located in Oakland, California. It is an open-end diversified management company within the meaning of Sections 4

and 5, and it is registered as such pursuant to Section 8 (a).[1]

The Trust Fund derives its capital funds from the continuous offerings to public investors of Participation Agreements. Such participations are sold either pursuant to a plan providing for a single payment of $1,000 or more, or under a periodic payment plan with monthly minimum payments of $10 over a 10-year period and a minimum investment of $1,200. The payments, after a deduction of applicable charges, are invested in stocks of various insurance companies. Since the Trust Fund is an open-end company, its Participation Agreements are subject to redemption at the option of the investor upon terms specified in the Agreement. As of December 31, 1955, the net assets of the Trust Fund amounted to about $215,000,000 (R. 5–6).

The investors in the Trust Fund have no general voting rights. The Trust Agreement provides, as required by Section 15 of the Act, that the Trust Fund's investment advisory and principal underwriting contracts must be approved annually by the board of

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[1] Section 5 (a) (1) defines an "open-end company" as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."

A diversified company means "a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer." (Section 5 (b) (1).)

directors or by a vote of investors representing a majority of investment units of the Trust Fund. Under the Trust Agreement, as also required by Section 15 of the Act, an assignment of the contract to serve as investment adviser or as principal underwriter automatically terminates such contract (R. 6–7).[2]

The Trust Fund, like many other funds, has no officers of its own and, until some time after the filing of the Commission's complaint, it had no board of directors. Since its organization in 1938, management functions for the Trust Fund have been performed by Insurance Securities Incorporated ("ISI") (referred to by the court below as "Service Company"). ISI was organized contemporaneously with the Trust Fund, and has been its sponsor, manager, and investment adviser as well as its principal underwriter (R. 4–6). ISI has no other business (R. 5). ISI receives a "creation fee", or sales load, for the sale of Participation Agreements, in addition to annual management and advisory fees. For 1953–1955, the three-year period prior to the filing of this action, ISI's fees were (R. 6):

| | 1953 | 1954 | 1955 |
|---|---|---|---|
| Creation fees | $1,847,948 | $2,960,222 | $4,354,300 |
| Administrative fees | 165,432 | 224,452 | 276,724 |
| Advisory fees | 97,687 | 134,009 | 166,357 |
| Other | 710 | 884 | 1,126 |
| Total | 2,111,777 | 3,319,567 | 4,798,507 |

[2] Section 2 (a) (4) of the Act broadly defines the term "assignment" to include "any direct or indirect transfer * * * of a contract * * * by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor."

As of January 1956, ISI had outstanding 166 shares of capital stock, $100 par value. Effective June 29, 1956, this stock was split into 166,000 shares, 10¢ par value. For convenience the transactions hereinafter described will give effect to this stock-split, except as otherwise indicated. As of June 30, 1956, ISI had total assets, per books, of $1,127,114. Stockholders' equity was $300,488, or $1.81 per share (R. 7, 16–17).

Since its issuance in 1938 and thereafter, the stock of ISI has been closely held. As of January 1956, and for years prior thereto, the four individual defendants, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan and Roy A. Haight, directors and officers of ISI, each owned 30,000 shares, or in the aggregate 72.6% of the total shares outstanding. The balance of the outstanding shares (27.4%) was owned by five other individuals (R. 7–8).

### The sale of control of ISI

The Commission's amended complaint alleges that on or about February 1, 1956, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan and Roy A. Haight (hereinafter sometimes referred to as "director-defendants"), acting either alone or in concert with others, embarked upon a plan to sell their controlling stock interest to a small group of purchasers. The sales were arranged through Kaiser & Co., an investment banker in San Francisco, California. The total shares of ISI capital stock sold to the purchasers between February and July 1956 amounted to 88,000 shares, or 53% of the total shares outstanding (R. 8).

Of these, 68,000 shares were sold by the director-defendants as follows (R. 8–9):

| | Shares | | Shares |
|---|---|---|---|
| Leach | 29,000 | Lonergan | 13,000 |
| Carr | 13,000 | Haight | 13,000 |

The price paid for the stock was $50 per share, although the net asset value of the ISI stock as of June 30, 1956, was only $1.81 per share (R. 9). For its services, Kaiser & Co. received a beneficial interest in the stock (R. 59–61).

While the successive transactions were separate in form, it appears that the sales and purchases of the ISI stock were, as alleged in the complaint (R. 8), interrelated, and in sum constituted a transfer of control within the definition of Section 2 (a) (9) of the Act.[3] The first block, sold in February 1956, amounted to 40 shares (40,000 shares after the 1,000 to 1 stock-split), or 24.09% of the outstanding ISI stock, of which the four director-defendants supplied 8 shares each (R. 56–57, 107–108). In May, 32 shares were sold, the four director-defendants supplying 5 shares each (R. 57–58, 108–109). In July, 16,000 shares (after the stock-split) were sold, all supplied by Mr. Leach (R. 59). The sales by these individual defendants thus accounted for about 40% of the outstanding ISI shares. The balance of approximately 13% was acquired from four other stockholders (R. 9, 58).

The possible sale of ISI stock was first brought to the attention of the Commission's staff in September 1955 by Mr. Elwood Murphey, a director of ISI and counsel for ISI, and Mr. William H. Bowen of Dallas, Texas,

[3] Under Section 2 (a) (9), 25% or more of the voting stock of a company constitutes presumptive control.

now a director of ISI. It was represented that the proposed sale was occasioned by the contemplated retirement of Messrs. Leach and Carr, two of the defendants who held 36.4% of the ISI stock (R. 117–120). The discussion centered about the impact of Section 36 of the Act in the light of the Opinion of the Commission's General Counsel made public on May 11, 1942, which sets forth as Commission policy the construction of Section 36 now urged by the Commission in this case.[4] Since no definitive plan was then indicated to the staff, it was suggested that "if a definite proposal for disposition of the stock developed, inquiry should be made to the Commission as to whether the proposed program would be considered as contravening the principles set forth in the 1942 General Counsel Opinion" (R. 119).

No such inquiry was ever made, and the stock sales came to the attention of the Commission's staff on July 2, 1956, when ISI filed its preliminary proxy solicitation material with the Commission (R. 97–98), and when the sale of all but 16,000 of the ISI shares had been consummated. Some months previously the possible sale of the ISI stock had been the subject of correspondence with Mr. Leland M. Kaiser, who has since become the president and a director of ISI and a director of the Trust Fund (R. 8, 55, 128–135, 141). In his letter to a member of the Commission, dated October 3, 1955, Mr. Kaiser disagreed with the Commission's interpretation of Section 36 and suggested that in the disposition of stock control in an investment adviser it would be better if control were re-

[4] The Opinion is published as Investment Company Act Release No. 354 (R. 124–128).

tained "in a relatively few hands, rather than the widespread holding of such stock" (R. 131).

Shortly before the February purchases of 40 shares, Kaiser & Co. wrote to Mr. Murchison, Dallas, Texas: "It seems preferable to purchase the shares in blocks of 10 each in 4 separate, unrelated accounts, although this is not necessary." (R. 106–107, 112); and the acquisition of these shares was thus executed (R. 57, 106–107). The second block of ISI stock purchased in May from the director-defendants appears to have been acquired pursuant to a written option, dated March 27, 1956. A specimen copy of an option of the same date specifically provides that it was subject to the condition that at least 75% of the optioned shares must be distributed in such manner that no purchaser shall, as a result, "hold individually a beneficial interest in, or right to vote more than, 24¾% of the voting shares" of ISI (R. 110); and the contract with Mr. Leach, dated July 7, 1956, for the sale of 16,000 shares contained the same condition (R. 67). All of these commitments were duly carried out: 10,000 ISI shares were sold to each of three companies controlled by Murchison Bros., Dallas, Texas; 37,000 shares to Mr. D. D. Harrington, Amarillo, Texas; and 21,000 shares to Richardson & Bass, a partnership, Fort Worth, Texas (R. 56–59). The Richardson & Bass purchase was subsequently divided, 10,000 shares going to Mr. Bass, and 11,000 shares to Mr. Richardson (R. 59).

While majority stock control was not acquired until later, some management prerogatives were assumed with the first acquisition. A few days after the Feb-

ruary purchases, Messrs. Bowen and Kaiser were elected directors of ISI; and Mr. Kaiser was also elected vice-president (R. 37). Mr. Kaiser has since become, and still is, president and a director of ISI (R. 34, 55), and he now is also a director of the Trust Fund (R. 141). Their election as directors and officers of ISI appears to have taken place pursuant to letter agreements dated February 17, 1956, addressed by Mr. Kaiser to Messrs. Leach, Haight and Lonergan, and under which Kaiser & Co. exercised options to purchase from each of them 8 shares of ISI stock. These letters set forth several conditions upon which the options were being exercised, committing each of the sellers, as long as he was a director or stockholder of ISI, to exert his best efforts (1) to have Messrs. Kaiser and Bowen elected directors of ISI; (2) to have Mr. Kaiser employed on a part-time basis as vice-president and member of the executive committee at an annual salary of $24,000 for a period of one and one-half years; and (3) to maintain the present dividend policy of ISI (R. 107–108). It was also provided that, for a period of three years or such other period as might be mutually agreeable, each of the sellers would vote salary increases "for only such officers or employees of the company [ISI] as do not presently occupy the four principal and highest salary positions of President, Vice-President and Treasurer, Secretary, and Vice-President of the company [ISI]" (R. 108). It seems that at that time the occupants of these positions were the four director-defendants (R. 38) and that these limitations would not be applicable to Mr. Kaiser who was elected vice-president a few days later (R. 37).

**The solicitation of proxies**

On July 17, 1956, shortly after the stock transactions previously described, ISI commenced the solicitation of proxies for a meeting of investors in the Trust Fund scheduled for August 15, 1956. The cost of the solicitation was paid for by ISI (R. 10–12, 21). The purpose of the meeting was to vote on several proposals formulated by ISI. Among these were the proposals for the reinstatement of the investment advisory and principal underwriting contracts between ISI and the Trust Fund (R. 28–32, 44, 46). The proxy soliciting material represented that ISI "is advised" that the "change in majority ownership" of ISI stock "may be considered an assignment" of these contracts and that such assignment may have had "the technical effect" of terminating the contracts (R. 21, 33). Investors were urged to act favorably on these and other proposals (R. 42, 46). The proxy material did not disclose the details of the transactions that led to the change in control of ISI. Nor were investors told of the net asset value of the ISI stock and the price the director-defendants were paid for their stock.

Another proposal submitted to investors in the Trust Fund was the creation of a board of directors for the Trust Fund to consist of seven members. The nominees for the board, chosen by the ISI management, were all directors of ISI, and included Messrs. Leach and Haight. It was proposed that upon election of the seven nominees, four would resign from the ISI

board (R. 25).[5] In view of the filing of the Commission's complaint and an order of the court, as more fully described below, two other directors of ISI were substituted for Messrs. Leach and Haight. (R. 141).

### The proceedings in the court below

In substance the Commission's amended complaint, filed on August 13, 1956, alleges that the payment for stock control at $50 per share, as against net asset value of $1.81 per share, represented no payment for any asset or assets owned by ISI; that the purchase price reflected the value of the perquisites and emoluments which ISI derives in the form of substantial fees from the Trust Fund under the investment advisory and principal underwriting contracts which under the Act are not assignable; and that the value attached to such contracts, being an asset of the Trust Fund, equitably belongs to the Trust Fund. The aggregate price for the total shares sold was approximately $4,240,720 in excess of their net book value. For the 68,000 shares sold by the director-defendants, the excess over net asset value was about $3,277,000. For appropriating such pecuniary advantages to their own account and benefit and for profiting from their fiduciary relationship to the Trust Fund, the director-defendants and ISI, it is alleged, are guilty of gross misconduct and gross abuse of trust within the mean-

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[5] Such resignations, we assume, were intended to meet the requirements of Section 10 (a), which provides that at least 40% of the board of a registered investment company shall consist of members who are not affiliated with the investment adviser. Under Section 2 (a) (3), the term "affiliate" includes a director.

ing of Section 36 of the Act. As a second cause of action, the complaint alleges that the proxy material sent to investors in the Trust Fund was false and misleading, as more fully discussed below.

The amended complaint sought, *inter alia,* a permanent injunction to restrain the director-defendants from serving as officers and directors of ISI and from serving and acting as directors of the proposed board of directors of the Trust Fund, and ISI from acting as investment adviser and principal underwriter of the Trust Fund; and an accounting for the monetary benefits which the director-defendants wrongfully and inequitably obtained as a consequence of the sale of their ISI stock (R. 14–15, 47–48). The complaint also sought preliminary relief, principally with respect to the use of the proxies at the meeting of the Trust Fund scheduled for August 15, 1956 (R. 14–15).

On August 14, 1956, the Commission brought on for hearing its motion for a preliminary injunction to restrain use of the proxies received from investors in the Trust Fund. On the same day, the defendants tendered in open court an undertaking to refrain, pending further order of the court, from voting the proxies in respect of the proposed reinstatement of the investment advisory and principal underwriting contracts and the proposed election of Abe P. Leach and Roy A. Haight as members of a Board of Trustees (or Board of Directors) to be created for the Trust Fund. The court below, upon stipulation of the parties, thereupon entered an Interlocutory Order, dated August 14, 1956, approving the undertaking and directing the defendants to comply therewith, and con-

tinuing the Commission's application for a preliminary injunction to September 7, 1956 (R. 48–49).

On August 24, 1956, the defendants below filed motions to dismiss each of the causes of action set forth in the Commission's amended complaint for failure to state any claim for relief. The defendants also filed nine affidavits (R. 52–88). The notice expressly states that the motions to dismiss were based on all pleadings and papers on file, including the affidavits (R. 53).[6] These affidavits were also submitted in support of their motion to dissolve the Interlocutory Order of August 14, 1956, and in opposition to the Commission's motion for a preliminary injunction (R. 53). The Commission opposed these motions and filed counter-affidavits (R. 96–140).

On August 30, 1956, by agreement of the parties, the court below entered a Second Interlocutory Order pursuant to which the Order of August 14, 1956, was dissolved and the Commission's request for a preliminary injunction was withdrawn. This Order expressly reserved jurisdiction to grant any and all relief sought in the amended complaint, if it is finally determined that the Commission was entitled to judgment, including such relief as the Commission may be entitled with respect to the use of the proxies of investors in the Trust Fund regarding the reinstatement of the investment advisory and principal underwriting contracts. The Order further provided that, pending a final de-

[6] A supplemental affidavit was filed by appellees on November 13, 1956 (R. 140–142).

termination in this action, the director-defendants shall not be elected or otherwise serve as members of the newly created board of directors of the Trust Fund, and shall not sell, or engage to sell, their remaining stock interests in ISI. Pending a final decision, the Order also restrained the payment of dividends on the ISI stock held directly or indirectly by the director-defendants, and any increase in the remuneration of the director-defendants, and other directors of ISI, subject to certain qualifications not here material (R. 93–95). The defendants' motions were continued to November 2, 1956, and, by a Minute Order entered on October 1, 1956, the hearing thereon was continued to November 16, 1956 (R. 95, 164).

On November 29, 1956, the court below issued its opinion granting defendants' motions to dismiss the amended complaint for failure to allege a cause of action under Section 36 of the Act (R. 142–150).[7] The court below did not decide the question of the violation of the proxy rules as alleged in the second cause of action, since by the terms of the complaint, this cause of action was dependent upon the first (R. 150). An order was entered on December 4, 1956, dismissing the complaint and dissolving the Second Interlocutory Order of August 30, 1956 (R. 151–152). This appeal followed (R. 152–153).

## SPECIFICATION OF ERRORS

In dismissing the Commission's amended complaint for failure to state a cause of action under Section 36, the court below erred because—

[7] The opinion of the court is published at 146 F. Supp. 776.

(1) it failed to rule that, on the facts alleged, the sales were a gross abuse of trust under the fiduciary standards of Section 36 and the policy underlying Section 15;

(2) it improperly construed the voting requirements under Section 15 as a substitute for the fiduciary standards incorporated in Section 36;

(3) it did not rule that, as alleged in the amended complaint, appellees are persons subject to the sanctions prescribed in Section 36;

(4) it did not rule that, as alleged in the amended complaint, the proxy solicitation violated Rule X–14A–9 of the Commission's Proxy Rules.

## SUMMARY OF ARGUMENT

It is conceded that ISI is the sponsor, manager, and investment adviser of the Trust Fund, as well as its principal underwriter; that ISI has no other business; and that the fees from the Trust Fund are the sole source of ISI's income. Since its organization in 1938, the Trust Fund has had no independent management of its own and ISI has performed all essential management functions for the Trust Fund. ISI clearly stood in a fiduciary relationship to the Trust Fund; and directors and officers, who are also controlling stockholders of ISI, stood in a like fiduciary relationship. As such, ISI and its directors and officers were under an affirmative duty to exercise their fiduciary responsibilities for the benefit of the Trust Fund and its public investors. Neither ISI nor its directors and officers could exploit their position for their personal gain. By the same token, the directors

and officers of ISI could not accomplish these same results indirectly through a sale of their controlling stock interest in ISI or otherwise.

I

(a) Section 36 authorizes the Commission to institute an action for temporary or permanent injunction to restrain for "gross misconduct or gross abuse of trust" a director, officer, investment adviser or principal underwriter of a registered investment company from continuing to act in any of these capacities. Section 36 derives its meaning from historic equitable principles which are incorporated therein and from the statutory purposes and policies of the Act.

The purpose of Section 36 and of other related provisions is to enforce fiduciary standards with respect to the management of investment companies, including their investment advisers and principal underwriters. This is one of the main themes of the Act, since, as the Congress found, investment companies, by reason of their liquidity and the marketability of their portfolio securities, had been particularly susceptible of abuse. One of the major abuses stemmed from the management contract which was not only a lucrative source of income but also an instrument of control and, as such, was the subject of indiscriminate trading by and for the benefit of management. Prior to the adoption of the Act, as the House Report states, there was "nothing to prevent irresponsible individuals and even individuals actually convicted of, or enjoined by the courts for,

ISI's fiduciary arrangements with the Trust Fund, and the selection of a successor rested exclusively with the Trust Fund and its investors under Section 15. To the extent that a purchaser was willing to pay a substantial sum for the privilege of succeeding to the contracts, those in control of ISI and in a strategic position to dictate or influence the course of the succession could not appropriate that opportunity for their own benefit. Under equitable principles "the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it", and the receipt of substantial payments for the succession in this case is inconsistent with "the necessary undivided loyalty owned by the fiduciary to his principal", *Perlman* v. *Feldmann,* 219 F. 2d 173, 176. It is also incontestable doctrine that a fiduciary, while he may resign at will, may not accept payment from one who wishes to succeed to his position (see pp. 56–64, *infra*). We submit that all of these doctrines were incorporated by the Congress into Section 36 and should be enforced by a court when its equitable jurisdiction is invoked thereunder.

## II

Though apparently assuming the fiduciary relationship between ISI and the Trust Fund, the court below concluded that the enforcement of equitable principles under Section 36, as urged herein, is neither necessary nor appropriate to eliminate the widespread abuses

that had resulted from trading in these fiduciary contracts. The court held that the Congress had provided a built-in remedy, namely, the termination of the agreements upon sale of stock control of ISI, thus leaving it to investors in the Trust Fund to determine by a majority vote whether to enter into new contracts with ISI under different control or with some other service company.

Courts of equity have never withheld relief for breach of trust merely because, by effective organization and intelligent use of their voting rights, security holders could displace a management not to their liking. On the contrary, in response to the growth of the modern corporation and its attendant complexities, courts of equity have exercised greater vigilance in the enforcement of fiduciary responsibilities, and equitable remedies have been correspondingly expanded to meet these developments. The same degree of vigilance and perception should be credited to the Congress when it directed the courts to enforce fiduciary standards under Section 36, especially since this is a regulatory statute enacted in the public interest and for the protection of investors. In such context, it has been said, "courts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved," *Virginian Ry.* v. *System Federation No. 40,* 300 U. S. 515, 552 (1937). Under the Act, as we have noted, one of the basic purposes was to strengthen and raise the level of fiduciary standards, not to weaken or lower it.

The application of Section 36 as herein urged is fully consistent with the provisions of Section 15. In casting their vote on any proposed new agreements, investors are not called upon to approve or disapprove the sale of stock control of the investment adviser or of the principal underwriter, or to exonerate any wrongful conduct on the part of those who have sold such control. Indeed, the responsibility for invoking and enforcing Section 36 has been entrusted to the Commission and the courts, not to public investors, and that responsibility cannot be vetoed or waived by a vote or the consent of the investors. If investors cannot do so by a vote specifically solicited or procured for that purpose, it is unreasonable to read such a result into Section 15.

The Commission's interpretation of Sections 15 and 36 aids in the achievement of the legislative policy to eliminate trading in investment advisory and principal underwriting contracts. Under the interpretation of the court below, the abuses of the past may recur. Succession to these contracts may once more be put on the auction block for sale to the highest bidder for the benefit of management, and the purchasers may be tempted to pursue hazardous or doubtful policies in order to recoup as quickly as possible the substantial price they paid for stock control and the succession to the agreements.

## III

Appellees argued below that, even if the transactions were wrongful under Section 36, ISI and the individual defendants were not persons subject to the sanctions thereunder. Section 36, they argued, ap-

plied only to an officer or director of an investment company, its investment adviser or its principal underwriter. They conceded, *arguendo,* that it would be wrong for ISI to sell its fiduciary position of investment adviser or principal underwriter, or for directors of the Trust Fund to do likewise with respect to their office. But, they urged, the alleged misdeeds in this case were not committed by ISI but by its directors and controlling stockholders, while the authors of the offending transactions were not directors and officers of the Trust Fund but rather of ISI. The court below, having determined that no wrongful act was committed within Section 36, did not reach this question, but it did indicate that if Section 36 were applicable, defendants would be persons within the reach of Section 36.

The policy of the Congress against trading in investment advisory and principal underwriting contracts cannot be evaded as a consequence of incorporation. Investors who invested their money in the Trust Fund did not put their faith in an abstract corporate entity but in professional managers and in the expert direction they had undertaken to furnish to the investors. If, for convenience or other reasons, the managers wished to incorporate, it was their privilege to do so. But, in exercising this privilege, they did not thereby escape from their self-assumed fiduciary obligations to the Trust Fund and its investors. Had these individuals themselves been serving as investment advisers or principal underwriters of the Trust Fund, it is conceded that they could not have sold the succession to their position without incurring

the sanctions of Section 36. They cannot avoid the statutory consequences because they committed the wrongful act indirectly. It is immaterial whether the offending transaction against the Trust Fund was committed by the ostensible or official occupants of the investment advisory or principal underwriting positions or by those who managed or dominated the investment adviser and principal underwriter.

It is familiar doctrine that liability is imposed upon a fiduciary who permits or condones activities, detrimental to the trust, committed by those employed to assist the fiduciary in managing the trust estate. In *Mosser* v. *Darrow,* 341 U. S. 267 (1951), the court said: "We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself" (341 U. S. at 272). ISI has no proprietary nor indefeasible interest in its investment advisory and principal underwriting relationships to the Trust Fund. Since ISI, in its corporate capacity, may not sell its fiduciary position, its directors and officers cannot sell ISI's fiduciary office for their own benefit as majority stockholders. From the point of view of the Trust Fund and its investors the dangers inherent in the trading of ISI fiduciary relationships are precisely the same, whether such trading is endorsed or undertaken by every member of the corporate body or by the controlling and managing organs of the corporation.

The Commission's position on this question is supported by the provisions of Sections 9 (a) (3) and 15.

Moreover, at the time of the sale of stock control the individual defendants were directors and officers of the Trust Fund. Section 2 (a) (12) defines the term "director" as including not only a director of a corporation but also "any person performing similar functions with respect to any organization, whether incorporated or unincorporated". In the instant case, the Trust Fund had no separate management of its own at the time, and all policy and management functions were performed on behalf of the Trust Fund by the directors and their associates on the board of ISI. They were in fact the directors of the Trust Fund.

## IV

The Commission's amended complaint alleges that in the solicitation of proxies for new contracts with the Trust Fund, Rule X–14A–9 of the Commission's Proxy Rules was violated. Rule X–14A–9 prohibits solicitation of proxies by means of proxy material which is false or misleading or which omits to state any material facts necessary to make any statement in the proxy material not false or misleading. In the instant case, it is conceded that the Commission's proxy rules were applicable to the solicitation of investors in the Trust Fund. It is not denied that the proxy material failed to disclose the price received by the individual defendants for their ISI stock, the net asset value of the ISI stock, and the pecuniary benefits the individual defendants have obtained as a consequence of their transfer of stock control. We believe

by the court in *Aldred Investment Co.*, v. *SEC*, 151 F. 2d 254, 260 (C. A. 1, 1945), certiorari denied, 326 U. S. 795 (1946), a case which arose under Section 36. Accordingly, in construing Section 36, the court, as a court of equity, should apply the historic equitable principles to their fullest extent, and thus give due and proper effect to the statutory measures and policies which Section 36 was designed to impliment.

As indicated in the legislative history, the Act is "the outgrowth of a comprehensive study and investigation of investment trusts and investment companies by the Securities and Exchange Commission pursuant to the direction of the Congress."[9] The Commission's reports covered every phase of the operations of investment companies and their management. These reports have been published by the Congress in several volumes under the title, *SEC Report on the Study of Investment Trusts and Investment Companies*.[10] While the Act as finally enacted reflected a compromise on a number of measures between the Commission and the industry, there was unanimous agreement that the evils and abuses disclosed in the Commission's reports required intervention through Federal legislation in "the national public interest and the interest of investors." See Sections 1 (a) and 1 (b) of the Act.

The need for Congressional legislation was particularly emphasized because of the special characteristics of investment companies and investment trusts,

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[9] H. R. Rep. 2639 on H. R. 10065, 76th Cong., 3d Sess. (1940) 4.

[10] S. Rep. 1775 on S. 4108, 76th Cong., 3d Sess. (1940) 5–6.

which were described as being "in essence institutions for the investment of the savings of small investors in securities, particularly the common stocks of industrial and other companies."[11] Because of their comparatively modest means, investors in securities of investment companies were generally found to be incapable of effective organization to protect their interests. In no small measure the appeal for this type of investment has rested on the overall representation that investors would fare better by entrusting their savings to the experienced and professional management of investment companies. Many trust funds have no boards of directors of their own, and their policies and operation are under the control and direction of the sponsor or one or more of the servicing agencies of the fund. Even where investment companies have their own boards of directors, effective control frequently rests in the hands of the investment manager, or underwriter company which may supply officer personnel and select the directors. In the instant case, for example, all of the management and service functions were from the very beginning performed by ISI, and the members of the newly created board of directors of the Trust Fund were nominees selected by ISI from its own board of directors.

The faith reposed by the investor in the professional management and his vulnerability to exploitation, were among the reasons that persuaded the Congress to adopt appropriate measures designed to

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[11] H. R. Rep. 2639 on H. R. 10065, 76th Cong., 3d Sess. (1940) 6.

directors and to designate the officers, while control of the proxy machinery, combined with the natural prestige of management and aided by the apathy of investors, effectively assured the election of the sponsor's nominees. Broad exculpatory clauses were commonly inserted in the contracts, and thus minimum responsibility was joined to maximum power, a conjuncture particularly attractive to those who had ulterior designs upon the investment companies they were seeking to control. These concomitant elements of control, both tangible and intangible, gave the management contract a value far in excess of its ostensible worth, and for the benefits of such control the sponsor or management was able to exact a substantial price from the purchaser.[15] Summarizing the matter in its report, the Commission stated:[16]

> * * * The shift in control was a private negotiation between the acquiring corporation or individual and the retiring management or sponsors of the acquired company.
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> Such shifts in control were usually advantageous to the retiring managers. Consequently, minority stockholders of these companies were represented in the shift of control to the acquiring individual only by sponsors and managers who may have been pecuniarily inter-

[15] These and other related aspects of the problem are documented in detail in SEC Report on Investment Trusts and Investment Companies, Part III, *Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies*. pp. 1029–1031, 1078–1094, 1278–1303, 1363–1366, 1874–1875, 1876–1888, 1912, 1918–1936, hereinafter referred to as "SEC Report."

[16] SEC Report, pp. 1029–1030, 1089–1090, 1920–1921.

ested in aiding, or at least not opposing, the objectives of the acquiring corporation or individual.

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In the absence of a substantial stock interest in the company, managers of investment companies held control either because of the inertia of stockholders combined with a control of the proxy machinery or by means of long-term management contracts. To acquire control in these situations, the acquiring company purchased the management contracts at attractive prices. These management contracts usually had been taken by the sponsors of investment companies prior to the public sale of the company's securities. They were solely the result of self-dealing upon the part of the sponsors. Usually the compensation provided for in these contracts was an annual fixed percentage of the corporate assets, so that the managers were assured of revenue whether or not the company's operations were successful.

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* * * Like voting trusts, management contracts can create control without the necessity for any financial stake in the enterprise by the managers and serve as a means of discouraging others who might attempt to acquire sufficient voting stock to depose sponsors who have little or no stock interest in the investment company * * * Furthermore, the management contract form of control avoids the necessity for offering to the public nonvoting stocks or voting trust certificates which, in view of the obvious disfranchisement involved, may be difficult to

sell. In addition, the period of duration and right of renewal of such contracts, are not at present regulated by statute. Finally, the standard of conduct required of the holder of the management contract can, by provisions in the contract, be set at a lower level than that which would be required by the courts of managing directors. * * *

Of 205 management investment companies analyzed, 105 had entered into management contracts at some time during the period 1927–1935 and at December 31, 1935, management contracts existed for 68 of such investment companies. These management contracts provided for a variety of management powers, duties, services, and accommodations. However, contractual limitations with reference to the services to be performed by the managers were at times minimized by the fact that persons ostensibly employed to provide advisory investment services have used loosely phrased provisions as bases upon which to assume all of the management functions. This was particularly true where the persons providing management also served as officers and directors, by reason of the difficulty of segregating their functions.

Several techniques were employed in the sale of management control. In some cases, compensation was paid for the direct assignment of the contract.[17] In other cases, payment for the assignment was reflected in the premium paid in the purchase of blocks of the investment company's capital stock held by the management.[18] In still others, when the manager or

[17] SEC Report, pp. 1297–1298.

[18] SEC Report, pp. 1929–1932, 2765–2766.

sponsor was a corporation, rather than a partnership or a sole proprietor, control of the contract was obtained by purchasing the stock of the management or service company at a substantial price, although the stock had little or no asset value apart from the contract and the incidents of control that went with it.[19] Indeed, by the sale of such stock, no assignment was even necessary, since the contract merely continued in the name of the corporate manager, the formal party to the contract.[20] These transactions often involved other benefits and advantages, depending upon the relative bargaining positions of buyer and seller. The sponsor-manager might insist on continuing to act as broker for the investment company or its successor.[21] In a great many cases, the directors, sponsors, or original distributors of the investment company's securities, agreed to aid in securing stockholders' approval of exchange offers proposed by the new management.[22] The purchasers generally insisted upon the immediate right to nominate or designate their own directors, although to avoid the semblance of an abrupt transition, it was sometimes arranged for seriatim resignations by the old board members.[23] Where management was vested in trustees under a voting trust, compensation might be offered for the resigna-

[19] SEC Report, pp. 98–101,2767–2768.

[20] SEC Report on Investment Trusts and Investment Companies, *Fixed and Semifixed Investment Trusts*, p. 39.

[21] SEC Report, pp. 1304–1306.

[22] SEC Report, pp. 1299–1300.

[23] SEC Report, pp. 1877–1881.

tion of a trustee who could not otherwise be dislodged.[24]

There is no need to dilate upon the evils and abuses involved in these practices. It is elementary that such practices are wholly at variance with the fundamental principle that management controls and prerogatives are powers in trust, and as such are not to be bought and sold in the market place as the personal effects of the individual managers. It is also evident that trading in fiduciary relationships necessarily involves conflicts of interests which are not likely to be resolved in favor of the beneficiaries. When trading is tolerated for any length of time, it attracts persons with a promotional flare though without professional qualifications, to the great detriment of investment companies, which, because of their high liquidity and the marketability of their portfolio, are "peculiarly subject to abuse."[25] Prior to the Act, investors who bought securities of investment companies generally had been persuaded to rely on the vaunted skill and experience of the sponsor and his associates, only to have control over their funds transferred to successors they did not choose or even know. The new management, forced to pay a substantial premium for control, might take the attitude that it "expected to make it up in management fees * * *,"[26] or seek other compensating advantages. In

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[24] SEC Report, pp. 1317–1318.

[25] *Aldred Investment Co.* v. *SEC*, 1951 F. 2d 254, 260 (C. A. 1, 1945), certiorari denied, 326 U. S. 795 (1946).

[26] Hearings before the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), p. 883.

some cases, control was purchased solely for the purpose of looting the acquired company.[27]

**(*b*) Section 36 must be construed in the light of Section 15 and other provisions of the Act to impose fiduciary obligations upon the investment adviser and principal underwriter**

One of the principal purposes of the Act was to make effective the fiduciary responsibilities of the investment company's management. In part, this was achieved by provisions designed to prevent or control the opportunities for self-dealing in transactions with or on behalf of the investment company. For example, under Section 10 (a) at least 40% of the board of directors of a registered investment company must consist of persons who are not officers, employees or investment advisers of the investment company or affiliates thereof.[28] Section 10 (b) (1) prohibits a registered investment company from employing as a regular broker a director, officer or employee, unless a majority of the board of directors is composed of persons not including such director, officer or employee; and this prohibition extends also to any other person, an affiliate of whom is such director, officer or employee. Parallel limitations are prescribed in Section 10 (b) (2) and (3) with respect

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[27] See, for example, *Insuranshares Corp.* v. *Northern Fiscal Corp.*, 35 F. Supp. 22 (E. D. Pa. 1940); *Gerdes* v. *Reynolds*, 28 N. Y. S. 2d 622 (Sup. Ct. 1941); see also SEC Report, pp. 98–107.

[28] The term "affiliated person" of another person is defined in detail in Section 2 (a) (3) and includes a person who owns 5% or more of the voting securities of such other person; an officer, director, or partner; an investment adviser; and, in the case of an unincorporated investment company not having a board of directors, the depositor.

to principal underwriters and investment bankers. In the case of common law trusts or other unincorporated companies, the limitations therein prescribed are, under Section 10 (h), extended to the investment adviser and depositor. In the case of an open-end investment company, if all but one of the members of the board of directors are affiliated persons of the investment adviser, the contract with the investment adviser must include the specific restrictions and limitations prescribed in Section 10 (d). Under Section 2 (a) (3), an investment adviser is an affiliate of the investment company, and, accordingly, certain transactions between them are subject to Commission scrutiny and review under Section 17 (b). The provisions of Section 17 (b) apply also to such transactions between a registered investment company and its principal underwriter.

Other provisions of the Act are cast in terms which emphasize broader standards of integrity and management's fiduciary responsibilities. Such, for example, is Section 17 (i), which provides that investment advisers and principal underwriters cannot be relieved of liability for "willful misfeasance, bad faith or gross negligence" in the performance of their contracts or for "reckless disregard" of their duties thereunder. Such, too, are the provisions of Section 9 (a). Under Section 9 (a) (1) a person is barred and disqualified from acting as an officer, director, or investment adviser for "reckless disregard" of their duties thereunder. underwriter for a registered open-end company, if within ten years he has been convicted of a crime involving the purchase and sale of securities. The same

disabilities are imposed under Section 9 (a) (2) upon any person "who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser * * *." Under Section 25 (c) a court, in a suit by the Commission, may enjoin consummation of a plan of reorganization with respect to a registered company, if the court finds that the plan involves "gross misconduct or gross abuse of trust" on the part of the company's officers, directors, investment advisers or other sponsors of the plan. As noted above, Section 36 gives a more comprehensive range to the management's fiduciary status, and provides for the removal of any officer, director, investment adviser or principal underwriter for any act or transaction which the court determines to constitute "gross misconduct or gross abuse of trust" with respect to the registered investment company.

Particularly germane in the latter connection are the provisions of Section 15, which are specifically concerned with the investment advisory and principal underwriting agreements—their approval, their duration, their renewal and termination, and their non-assignability. Section 15 (a), which deals with investment advisory contracts executed after March 15, 1940, provides in pertinent part: [29]

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[29] Under Section 15 (d), an investment advisory contract in effect prior to March 15, 1940, may continue for a maximum of five years unless sooner terminated by assignment or otherwise, and a new contract is executed in accordance with the statutory provisions. After March 15, 1945, such contracts must conform to the requirements of Section 15.

> * * * it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, * * * has been approved by the vote of a majority of the outstanding voting securities of such registered company and—* * *
>
> (2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;
>
> (3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and
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> (4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

Under this provision, the investment advisory contract is no longer regarded as a private arrangement to be dictated by the sponsor or promoter; nor are long-term contracts permitted. The contract, either initially or after termination of a prior contract, must be approved by a majority vote of the outstanding securities of the investment company, and it may not continue in effect for more than two years unless annually renewed by such majority, or by the board of directors, if any. When it is renewed by the board

of directors, the renewal requires, reading Section 15 (a) (2) with Section 15 (c), a majority vote of the directors who are not the investment advisers and as such parties to the contract, or affiliated persons of any such party; otherwise it can be renewed only by a vote of security holders. Under subsection (3) the investment advisory agreement may be terminated without penalty on sixty days' notice to the investment adviser; and subsection (4) provides that the agreement is automatically terminated "in the event of its assignment by the investment adviser."

Section 15 (b) contains substantially similar provisions with respect to the principal underwriting agreement. It provides in pertinent part: [30]

> * * * it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract * * *
>
> (1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and
>
> (2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

The initial or the new agreement with the principal underwriter must be approved either by the board of

[30] Section 15 (d), note 29, *supra*, applies also to the principal underwriting contract.

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directors of the investment company or by a vote of the outstanding securities of the investment company in accordance with the conditions prescribed in Section 15 (c). Annual renewals thereof, as provided in subsection (1), call for the same procedures as those prescribed with respect to the investment advisory agreement under Section 15 (a) (2); and the principal underwriting agreement is automatically terminated upon its assignment.[31]

It should be noted that the term "assignment" in Sections 15 (a) (4) and 15 (b) (2) is not to be taken in its ordinary or more obvious meaning. In its statutory context, as defined in Section 2 (a) (4), it has a broader meaning. It includes any "direct or indirect" transfer. Also included is an "hypothecation" of the contract, for the reason that, when such contract is pledged, the character of its performance might be influenced by the investment adviser's or principal underwriter's commitments to the pledgee instead of solely by his fiduciary obligations to the investment company. It includes also transactions

[31] It is not disputed that, as alleged in the complaint (R. 6–7), the principal underwriting and investment advisory contracts between ISI and the Trust Fund are subject to Section 15. Though initiated about 1938, they have long since been amended to conform with the provisions of Section 15. Since the Trust Fund has had no management of its own, annual renewals of these agreements have been submitted to a vote of investors in the Trust Fund. With the creation of a board of directors for the Trust Fund in September 1956, annual renewals under Section 15 may now be approved by the board of directors (R. 26). It was on the assumption, though not conceded, that the sale of the ISI stock had terminated these agreements that ISI solicited proxies of the investors in the Trust Fund and urged approval of new contracts (R. 21).

that conventionally would not be considered as involving a sale or transfer. An assignment is deemed to take place even when the critical event is an act of God. For Section 2 (a) (4) excludes from the definition "an assignment of partnership interests incidental to the death * * * of a minority of the members of the partnership having only a minority interest in the partnership business." By necessary implication an "assignment" of the investment advisory and principal underwriting contracts takes place upon the death of a partner or partners having a majority interest in the partnership. The underlying assumption is that in the latter circumstances a realignment in majority control of the members constituting the partnership may substantially affect the advisory or underwriting services rendered by the partnership. The same statutory consequences follow on the withdrawal of a partner or on the admission of a new partner.

The contingency that the investment adviser or principal underwriter may be a corporation is likewise provided for in Section 2 (a) (4). The Congress fully understood that, as disclosed in the Commission's investigation, sponsors and their allies might incorporate their professional talents and render their services to the investment company as agents or officers of the corporation to be engaged as the principal underwriter or investment adviser. Under such circumstances, actual management of the investment company could be effectively transferred by selling stock control of the corporate investment adviser or principal underwriter, without

the formality of an assignment of the underlying contract. To obviate this transparent device and disregarding, in effect, the separate corporate entity, Congress in Section 2 (a) (4) also defined as an assignment "any direct or indirect transfer * * * of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor." So defined, and as the court below stated (R. 146), the sale of a controlling block of ISI stock by stockholders of ISI constitutes an assignment of the Trust Fund's investment advisory and underwriting agreements with ISI, even though in form the sale of the stock involved no dealing with or by ISI itself or the Trust Fund, and such sale terminates these agreements.

Section 15, as viewed in terms of Section 2 (a) (4), represents a Congressional determination that the investment adviser and principal underwriter each occupies a fiduciary office in respect of the investment company; that his contractual agreement with the company constitutes an undertaking of a fiduciary character; and that its purported sale or transfer, in whatever guise or form, is wholly inconsistent with this fiduciary undertaking. As was stated in explanation of Section 15:

> Here you have a situation where a person assumes a fiduciary obligation; he is the manager of other people's money. If he is through with the job, he ought to go home. However, instead of that they take these 10-year contracts which they have the right to assign to someone else.

> This provision says that the management contract is personal, that it cannot be assigned, and that you cannot turn over the management of other people's money to someone else.[32]

**(c) The decision of the court below is contrary to the policy of the Act and equitable principles embodied in Section 36**

In its amended complaint, the Commission alleges that the ISI stock was sold at $50 per share, or at an aggregate price of $4,400,000 for 88,000 shares, although its asset value was only $1.81 per share (R. 9). It is further alleged that the price paid by the purchasers did "not represent the real and actual value" of the ISI shares; that it "represented no payment for any asset or assets owned" by ISI; and that it "reflected the value of the perquisities and emoluments" which ISI derives from its agreements with the Trust Fund, which agreements, being nonassignable, are not disposable assets of ISI (R. 9–10). In substance, the Commission views the transaction as only nominally a sale of stock. The unique and substantial "asset", for which the purchasers paid about $4,000,000, is the succession to ISI's contractual and fiduciary arrangements with the Trust Fund, which ISI and the director-defendants cannot sell either directly or in the guise of a premium on ISI stock.

The court below did not make any determination as to the value of the ISI stock, nor apparently did it deem it necessary to do so. Viewing the transaction merely as a sale of ISI stock and no more, the court below concluded that no breach of trust within the meaning of Section 36 was, or indeed, could have been

[32] Hearings before the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), p. 253.

committed. The court held that Section 36 had reference to acts of misconduct relating "to obligations respecting the Trust Fund itself" (R. 148), and that the transactions in the ISI stock did not involve assets of the Trust Fund or relate to the management of its affairs (R. 147).

We submit that the Commission's construction of the transactions is more realistic. Since the net asset value of the ISI stock was only about 3.6% of the purchase price, the purchasers were obviously not buying merely a proportionate interest in the tangible assets of ISI. Further, since from the time of their contemporaneous organization, ISI has been engaged exclusively in servicing and managing the Trust Fund, it is equally clear that the purchasers were not seeking control of ISI for the purpose of undertaking other and untried ventures. The principal object of the sale necessarily was ISI's strategic position with respect to the Trust Fund, the control of which would assure the purchasers the continued benefits of the investment advisory and principal underwriting arrangements with the Trust Fund. Insofar as there may be any genuine issue as to the real character of the stock transactions, or if appellees may want to urge that the stock as such was worth substantially close to $50 per share, the Commission is entitled to have these issues resolved by a trial on the merits. Surely, they are not susceptible of summary disposition on motion. See *Sartor* v. *Arkansas Natural Gas Corp.*, 321 U. S. 620, 628–629 (1944). Indeed, if this Court agrees with the Commission that, as a matter of law, the sale of the

ISI stock must be limited to a price which accords no value to the appurtenance of control and ISI's strategic position with respect to the Trust Fund, appellees, as fiduciaries, have the burden of proving that $50 per share was that price. *Perlman* v. *Feldmann,* 219 F. 2d 173, 178 (C. A. 2, 1955), certiorari denied, 349 U. S. 952 (1955).

That the character of the transaction should be considered in all of its factual dimensions is clearly indicated by *Insuranshares Corp.* v. *Northern Fiscal Corp.,* 35 F. Supp. 22 (E. D. Pa., 1940). This case involved a suit by an investment company against its former directors, officers and certain stockholders who had sold stock control at a substantial premium to purchasers who subsequently looted the company. The court held the defendants liable for breach of trust. In response to the preliminary contention that no wrongful act against the company had been committed because the defendants' dealings with the purchasers had involved only a sale of stock, the court stated (35 F. Supp. at 24):

> The defendants have insisted throughout the case that the transfer of December 21, 1937, was simply a sale of stock, the passing of control being merely a normal concomitant, and most of their argument was based upon this premise. This view, however, I think is fundamentally wrong. If the whole record be read, I do not see how the transaction can be considered as anything other than a sale of control, to which the stock sale was requisite, but nevertheless a secondary matter * * *. The buyers were primarily interested in getting

> control of the corporation together with such stock ownership as would make that control secure and untrammelled, and the sellers were primarily interested in getting as much money as possible for what they had to sell—both the control and their interest in the assets.

Likewise, in *Benson* v. *Braun,* 286 App. Div. 1098, 145 N. Y. S. 2d 711 (2d Dep't 1955), the appellate court sustained the sufficiency of a complaint which charged that fiduciaries had sold control by the sale of stock at a price far in excess of its fair value "on the theory that the said excess was paid for the resignations, for the election of the purchasers' nominees, and for immediate control of the corporation."[33]

The court below in this case also construed much too narrowly the applicable fiduciary standards. Under equitable principles, "the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it", *Perlman* v. *Feldmann,* 219 F. 2d at 176. Since, as we urge, the director-defendants here were offered and paid $50 per share for their strategic position to dictate or influence the succession to the investment advisory and principal underwriting arrangements with the Trust Fund, they, as directors and officers and majority stockholders of ISI, could not exploit such position for their own account and benefit.

[33] On remand, the court, after trial, held that the plaintiffs had failed to prove the allegations in the complaint. *Benson* v. *Braun*, 155 N. Y. S. 2d 622 (Sup. Ct. 1956).

Under Section 15, the privilege of choosing a successor adviser or underwriter rests with the Trust Fund and its investors. If, as in this case, purchasers were willing to pay substantial sums for the opportunity to succeed to the management contracts, those in control of ISI could not appropriate that opportunity for themselves, but, as fiduciaries, must exercise it for the benefit of the investors in the Trust Fund.[34] The appropriation of that advantage for their own account did "not betoken the necessary undivided loyalty owed by the fiduciary to his principal", *Perlman* v. *Feldmann,* 219 F. 2d at 176.

In ruling that the sale of control of ISI did not involve a transaction "in respect of" the Trust Fund, the court below overlooked that under Section 15 and Section 2 (a) (4), the sale of stock control of ISI is regarded as a transaction in the underlying contracts as well. The court below also failed to take into account the organic relationship subsisting between the investment company and its investment adviser. The very close link between them is no mere historical fortuity. Nor is it sufficient to say that the advisory service is merely important to the investment company. It is, in fact, essential. A management investment company is more than an inert aggregate of portfolio securities. It requires a management, and those who are persuaded to buy investment company

[34] *Cf. Irving Trust Co.* v. *Deutsch*, 73 F. 2d 121 (C. A. 2, 1934), certiorari denied, 294 U. S. 708 (1935), holding that directors, as fiduciaries, may not intercept or appropriate for their own account a transaction which should be available for the benefit of the corporation.

trust, or registered face-amount certificate company." The securities of a unit investment trust, like those of an open-end company, are by their terms redeemable,[38] while certificates of a registered face-amount company are required to provide for a cash surrender value, a right akin to redemption.[39]

The placing of the investment adviser and principal underwriter within the echelon of management should not be viewed as a suggestion that they are thereby denied all autonomy in their affairs. For each, within the general domain of its own organization, there may be functions and tasks that, as the court below intimates, lie "within the area of its own independent affairs" (R. 147). But matters that concern its fiduciary responsibilities to the investment company or that may affect the character of the latter's operations or obligations to its public investors cannot be so characterized. Clearly, acts and transactions within this range of consequences transcend the limits of such autonomy. There can be no doubt that, in view of Section 15 and the equitable principles which we discuss more fully below, the sale of the agreement between the investment company and its investment adviser or principal underwriter, either directly or in the form of a sale of stock control, must likewise be beyond these limits. The contrary view adopted by the court below in this case reflects its conception that involved herein is merely a sale of stock.

While Section 10 (a) now prescribes the maximum permissible number of common directors or officers

[38] See Sections 4 (2) and 5 (a) (1) of the Act.

[39] See Section 28 (d) of the Act.

for the investment adviser and the investment company, it is clear that, subject to this and other related limitations, these affiliations, as indicated in Appendix B, *infra,* still continue, and historic origins as well as essential operational ties make such affiliations both natural and understandable.[40] Appendix B also indicates that in a substantial number of cases all of the fund officers are paid by the investment adviser and that only in a relatively few cases is this practice either not in force or limited to common officers.[41] Moreover, directors of the fund frequently are nominees of the adviser or underwriter, who may also select its officers and other personnel.[42] In the instant case the board of directors for the Trust Fund, first established since the filing of this lawsuit, consists of 7 members, all nominated by the ISI management. All of these 7 previously were members of the ISI board, and 4 resigned upon their election presumably in order to comply with the provisions of Section 10 (a). The responsibilities normally exercised by officers apparently are still discharged by ISI personnel.

Further, in Appendix C, *infra,* are listed 150 firms serving as investment advisers or principal under-

[40] See Appendix B, *infra,* for data on common affiliations with respect to investment advisers and principal underwriters for 57 registered open-end investment companies having net assets of $25 millions or more.

As noted on page 5 thereof, the data in this Appendix are based upon public information.

[41] See Appendix B, column 9.

[42] In some cases, the fund may control the adviser or underwriter. This is not material for our analysis, which is concerned with common control or influence. The direction from which it emanates is of no consequence.

writers, or both, for open-end funds.[43] Like ISI, about 32% of these have no other business except servicing the open-end fund or funds therein indicated, and from sources available to us no other business is indicated for about another 25%. This makes a total of about 57% of companies which are either wholly or almost entirely engaged in servicing a particular open-end fund or funds.[44] In some cases, the investment advisers or principal underwriters are partnerships. More often, they are corporations which, with two exceptions, have relatively small amounts of stock outstanding, and their stock is closely held.[45] Aside from what appears on the balance

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[43] As noted on p. 16 of Appendix C, the data for these firms are based on information available to the public.

[44] The remaining firms appear to be engaged in varying degrees in such related businesses as investment banking, investment counselling for individual accounts, securities brokerage, or other businesses not readily classifiable.

We take this occasion to correct an error made in the course of assembling the data for Appendix C. On page 14 of this Appendix, State Street Research & Managament Corporation is listed as adviser and underwriter for State Street Investment Corporation. The service company performs only advisory service. See Appendix B, p. 1.

[45] Such data with respect to the corporate adviser or underwriter is set out in column 6 of Appendix B. To the left are the data showing, where available, the amount of shares outstanding; to the right are the figures showing their percentage distribution. For example, for United Funds, Inc., seventh in the list of open-end funds, the investment adviser, Continental Research Corp., has 8 shares outstanding, 2 stockholders holding 50% of the outstanding stock. The number "2" and the corresponding figures for the other companies do not refer to the total number of stockholders in the corporation, except where the context so requires. As previously noted, the data in Appendix B are limited to funds with net assets of $25 millions or more.

sheets, their real income producing "asset" obviously lies in their underwriting and advisory connections with the funds. For these reasons, the stock of such corporations is not generally traded in the market, and, as in the case of ISI, significant transactions in the stock would usually involve shifts in control.

The decision by the court below will bring once again into focus the danger of trading in these fiduciary arrangements, since existing concentrations of stock control and the small amount of outstanding stock provides ready-made occasions for the sale of stock control. It is hardly likely that the significance of the investment adviser's and principal underwriter's close connections with the fund or funds will be ignored by the sellers and buyers in their negotiations for the sale of stock control. In any negotiated price in excess of net asset value, the component value attached to these fiduciary relationships will not merely be present but, as in this case, will be substantial and the most important. Although under Section 15 these contracts are terminated, no effective opposition to any new contracts with the successors, as we shall see (pp. 80–81, *infra*), is likely to develop among public investors; nor, significantly, within the fund management, some of whose influential or controlling members, as in this case, are likely to be parties to the sale.

We believe that, once the interlocking and fiduciary ties between the investment company and its adviser or underwriter are fully considered and the stock transactions are realistically appraised, there can be no dispute about the fundamental proposition that a fiduciary cannot exploit his position of trust for his

own benefit by selling his office directly, through the sale of stock control, or in any other manner. This is well-established in equity with respect to trustees, receivers, administrators, guardians, and corporate directors or officers. It has been set forth time and again, as we shall see, in the decisions of courts of equity, and has received the full endorsement of authoritative commentators.[46] It has not been thought that, for effective administration of an estate or for successful pioneering efforts in a business enterprise, the fiduciary, to whom these achievements are credited, may auction off his position on the eve of retirement as an additional reward for work well done. The same fiduciary standards are necessarily applicable under Section 36 with respect to the investment adviser and principal underwriter or their controlling persons. The declaration by the Congress in Section 15 that the investment advisory and principal underwriting agreements are not articles of commerce for trading in the market lend additional support for reading these standards into Section 36.

The fiduciary principle, as we read it in the light of the policy of the Congress and the provisions of Section 36, was announced by Vice-Chancellor Sir John Stuart one hundred years ago in *Sugden* v. *Crossland*.[47] In that case, a trustee under a codicil to a will retired from his office and, in consideration of £75, executed a deed appointing as his successor a person who had been named as trustee in the original

[46] Perry, *Trusts and Trustees* 712 (7th ed. 1929); 3 Cook, *Corporations* 2428 (1923).

[47] 3 Sma. & Giff. 192, 65 Eng. Rep. 620 (1856).

will. In cancelling the deed of appointment and in directing the selling trustee to account to the estate for the funds, the Vice-Chancellor said:

> This is a very extraordinary case * * * There are cases on record in which a trustee has paid money in order to induce other people to act with him in the execution of a trust, and in which he has been allowed the money so paid. I do not remember a case where the office of a trustee has been purchased for money. * * * It is a well-settled principle that, if a trustee make a profit of his trusteeship, it shall enure to the benefit of his *cestui que trusts.* Though there is some peculiarity in the case, there does not seem to be any difference in principle whether the trustee derived the profit by means of the trust property, or from the office itself * * * [48]

The court declined to consider the mitigating suggestion that the parties, who were in an "humble station of life", were ignorant that their arrangement violated any rules of equity.

This principle has also been followed by our courts. It was clearly illustrated in *McDonald* v. *Forbes,* 54 Cal. 98 (1880). The defendants were dealers in the stock of a corporation managed by five trustees, of which plaintiff Forbes was one. Since there was dissension within the management, the defendants induced Forbes to resign so that "they might put some friend in his place." In consideration they agreed to secure a debt owed to Forbes by a third party. When the debt was not paid, Forbes brought suit

[48] 3 Sma. & Giff. at 193–4, 65 Eng. Rep. at 621.

against the defendants. The court held the agreement unenforceable, since an officer, although he might resign as he pleases, cannot do so for a price. The court said:

> It is not necessary to cite authorities to show that a contract is void if a portion only of the consideration is illegal. It does not appear to us to be at all doubtful, that if the whole or a part of a consideration be that a trustee resign his trust, the consideration is illegal. It is *contra bonos mores.* Trustees of corporations owe duties to others besides themselves; they have been placed in a position of trust by the stockholders, and to those stockholders they must be faithful. It is a violation of that trust for them to be bought out of office. They may resign when they please, but they must not make profit or benefit themselves in the matter of such resignation.

In *McClure* v. *Law,* 161 N. Y. 78, 55 N. E. 388 (1899), the defendant, president of an insolvent insurance company, and some of its directors agreed to resign and to transfer control of the corporation by electing the purchaser and others to the vacancies. In consideration the purchaser paid him a sum of money to reimburse him for the payment of the corporation's notes which were not collectible. The court construed the arrangement as involving a payment for the election of the purchaser and his associates as directors and for the control and management of the corporation. Although it appears from the opinion of the lower court that the purchaser, subsequent to his election, looted the company, the appellate court did not

rely upon these circumstances but held the defendant liable for the sale of his fiduciary office. It held that as president and director he was liable to the corporation

> for all moneys that came into his hands by virtue of his official acts * * * The election of directors, and the transfer of the management and property of the corporation, were official acts, and whatever money he received from such official acts were moneys derived by virtue of his office, for which we think he should account.

The court analogized the case before it to that of a trustee who "retired from the office in consideration that his successor paid him a sum of money."

The same principle was applied in *Moulton* v. *Field,* 179 Fed. 673 (C. A. 7, 1910), in connection with the sale of a management contract. In that case, Gray, who had organized Western Indemnity Company, obtained a 25-year contract which gave him sole control and management of the company, including control of the proxy machinery. His annual salary was $12,000. Subsequently, when he became seriously ill, and his contract had four years to run, Gray offered to sell his contract for $125,000 to Rosenfeld, who was willing to pay if he could become general manager. Moulton, president of Western, was persuaded to join in the scheme on Rosenfeld's promise that when he became general manager, he would increase Moulton's salary and would turn over to Western the business of another insurance company for $200,000. It was understood that out of this amount Rosenfeld would pay Gray $125,000 and pocket the difference. It later appeared that the assets turned

over by Rosenfeld were worthless. The court affirmed a judgment against Moulton for the full $200,000, on the theory that if the succession to Gray's general management contract was worth $125,000, the sale (if lawful) should have been made for the benefit of Western. The court said (179 Fed. at 675):

> With this proxy control in Gray's hands, the directors came to regard Gray, and not the owners, as the master of the business. When Gray became incapacitated, his employment should have been ended on that account; and in all probabilities would have been, if the directors had considered themselves servants of the policy holders instead of dependents of Gray. If the succession was worth $125,000 in the market, the sale (if it were lawful) should have been made by the directors for the benefit of the owners of the business, not of Gray. For Gray had nothing legally saleable. His contract, being for personal service, was not assignable; and the resolution of the directors really created a new contract with Rosenfeld (the purchaser). So the arrangement * * * by which the office of general manager and the proxy control were sold to Rosenfeld and the consideration turned over to Gray instead of into the treasury, was a betrayal of trust.

Likewise in *Sherman & Ellis* v. *Indiana Mutual Casualty Co.*, 41 F. 2d 585 (C. A. 7, 1930), in a suit to enforce a contract to permit a management company to manage the affairs of a casualty company for a period of twenty years and to appoint its underwriting manager and its "executive head," the court held that, since management responsibilities were nonas-

signable, the contract was void as against public policy.[49]

Courts of equity have enforced the same principle when the fiduciary or corporate office has been sold as part of a package which formally appeared as a sale of stock control. Looking at the substance of the matter, the courts would not accept the surface form of the transaction.[50] The ingredients of the sale have been thoroughly sifted in order to determine how much of the purchase price might be legitimately attributed to the investment value of the stock. Directors or officers have been held liable for breach of trust when, upon the evidence, it appeared that the excess ''was not so much a part of the price paid for the stock owned or controlled by the defendants as a secret consideration paid to them for the purpose of gaining immediate control of the organization of their corporation'', *Porter* v. *Healy,* 244 Pa. 427, 91 Atl. 428 (1930).

The immediate issue in *Bosworth* v. *Allen,* 168 N. Y.

[49] *Cf. West* v. *Camden*, 135 U. S. 507 (1890), in which the court held a contract by a director to keep another permanently in place as an officer of the corporation, void as against public policy. The court said that the rule was analogous to that applicable "to the case of a public office." 135 U. S. at 520.

[50] The problems relating to the sale of stock control have been the subject of considerable discussion in the legal literature, though not with particular reference to the statute in this case and its underlying policy. See Jennings, *Trading in Corporate Control*, 44 Calif. L. Rev. 1 (1956); Leech, *Transactions in Corporate Control*, 104 Penn. L. Rev. 725 (1956); Hill, *The Sale of Controlling Shares*, 70 Harv. L. Rev. 986 (1957); *Comments:* 54 Mich. L. Rev. 399 (1956); 22 U. of Chi. L. Rev. 895 (1955); 40 Cornell L. Q. 786 (1955); 68 Harv. L. Rev. 1274 (1955); 40 Va. L. Rev. 195 (1954); 19 U. Chi. L. Rev. 869 (1952).

157, 61 N. E. 163 (1901), was a procedural point on alleged misjoinder of two causes of action, but the substantive principles, in terms of which the issue was resolved, makes this decision pertinent here. There recovery was sought on the theory that the excess value of the shares was paid for the resignation of the directors and on the ground that the defendants were liable in tort for transferring control to irresponsible persons who mismanaged the company. The court reversed the lower court, which had dismissed the action for improper joinder of two causes of action, and held that in an action for an accounting the plaintiff was entitled to relief on both grounds. The court said that if directors of a corporation

> are treacherous to its interests, and appropriate its property, or intentionally waste its assets, or take money for official action, or "sell out" by resigning, and thus giving control to others, they are liable to account in equity to the corporation or its representatives, not only for the money or property in their hands, but also for such as they fraudulently disposed of or wasted, as well as for the damages naturally resulting from their official misconduct; and even, as we have recently held, for money received by virtue of their office. *McClure* v. *Law,* 161 N. Y. 78, 55 N. E. 388.

*Perlman* v. *Feldmann,* 219 F. 2d 173 (C. A. 2, 1955), certiorari denied, 349 U. S. 952 (1955), carried this approach one step beyond. In that case, a 37% block of shares of Newport Steel Corporation was sold by Feldmann and members of his family. Feldmann was president, chairman of the board and a dominant

stockholder. The sales price was $20 per share although the book value was $17 and in recent sales in the over-the-counter market the price had not exceeded $12 per share. The purchasers were end-users of steel. Pursuant to the agreement of sale, all members of the board of directors resigned immediately after the sale, and the purchasers' nominees were elected in their stead. Although no damage to the corporation was established, the court held the defendants liable to the plaintiff shareholders. The court stressed that the sale occurred during the Korean crisis when steel was in short supply, and that the purchasers' willingness to pay $20 per share reflected in part a premium paid for the power to control the distribution of the corporate product. It accordingly remanded the case to the district court for an accounting of that portion of the excess of $12 per share which reflected the value attached to this managerial prerogative, which, in the court's view, did not belong to the defendants but to the corporation and its shareholders.[50a]

*Young* v. *Higbee Co.*, 324 U. S. 204 (1945), also provides an excellent illustration of the vitality and flexibility of the doctrine. In that case, Potts and Boag, preferred stockholders, were not officers or directors of the company, nor even dominant shareholders, and their fiduciary status was based merely upon their commanding position in a lawsuit which they themselves had initiated. These stockholders appealed from an order confirming a plan of re-

[50a] In its decision of July 18, 1957, the district court held the defendants liable in the aggregate amount of about $1.3 millions. *Perlman* v. *Feldmann*, D. C. Conn., Civil Action No. 3086.

organization under Chapter X of the Bankruptcy Act, urging that the plan was not fair and equitable because it did not subordinate certain prior debt claims to the preferred stock. During the pendency of the appeal, two debt claimants purchased the stock from Potts and Boag on condition that they dismiss the appeal. At the time, the market value of their preferred stock was $17,000, for which they received $115,000. The court held that, having appealed on a matter which concerned the entire class of preferred stockholders, they had assumed a fiduciary responsibility to other members of the class, and could not use their statutory right to be heard in the proceedings and to appeal as a means for obtaining personal gain. Since the price they received was not for the stock alone, they were held accountable to the other stockholders for the difference between the sales price of their stock and its market value, even though the district court had rejected their objections to the plan, and there was no indication that they would have succeeded had they prosecuted the appeal.[51] See also *Clarke* v. *Greenberg,* 296 N. Y. 146, 71 N. E. 2d 443 (1947).

It should be noted that in cases such as *Perlman* v. *Feldmann, supra,* a substantial or a predominant portion of the price represented the investment value of the stock in a going enterprise. The breach of trust was predicated upon a determination that the excess over investment value was paid for the surrender of the corporate office or other managerial prerogative,

[51] For the proceedings on remand, see *Potts* v. *Young*, 161 F. 2d 597 (C. A. 6, 1947).

and accountability was accordingly limited to this portion of the purchase price. Since valuation techniques are not exact and yield only approximations, the determination of the proscribed component may occasionally be complicated in terms of proof. In a close case, therefore, if the two components of the price are not quite apparent, the courts, as a practical matter, will deny recovery. In these circumstances, the transaction will be regarded essentially as a sale of stock, although if a prima facie case is established, the burden of explanation is cast upon the fiduciary.[52]

When the transaction involves the sale of the office or the management contract alone, unaccompanied by a sale of stock, these complexities are not present. Then the very act of sale constitutes the breach of trust and the purchase price itself is the measure of the fiduciary's liability.[53] The same, to a very large degree, is equally true in the sale of a controlling stock interest in investment advisory or principal underwriting companies such as ISI which, as we have seen, often have no other significant business. Since such companies are principally or exclusively engaged in fiduciary undertakings, the substantial element in the price for the stock will represent payment for the succession to these undertakings. The assets of these

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[52] See *Perlman* v. *Feldmann*, 219 F. 2d 173, 178 (C. A. 2, 1955), certiorari denied, 349 U. S. 952 (1955). It may be noted that Judge Swan, dissenting in this case, felt bound by the district court's findings that as a control block the stock of Newport Steel was worth $20 per share and that there was no evidence as to its value "if shorn of its appurtenant power to control distribution of the corporate product" (219 F. 2d at 179–180, fn. 1).

[53] See *Sugden* v. *Crossland*, and *Moulton* v. *Field*, discussed pp. 56–57, 59–60, *supra*.

companies, which may be regarded as freely and legitimately transferrable, are likely to be balance sheet items that are relatively small in relation to the total purchase price. In the instant case, the price allocable to the value of the stock was relatively insignificant. By far the largest element in the price, as alleged in the complaint, represented payment for ISI's controlling position with respect to the Trust Fund.[54]

There is no need to emphasize that the conceptions of fiduciary duty and remedy exemplified in these cases were not created by statute. They were developed by courts of equity as instruments of public policy in order to prevent corrosion of the fiduciary responsibilities of those who have undertaken to manage money or property of others or to act on their behalf. The public policy expressed by the Congress under the Act is both emphatic and inclusive. It states in effect not only that the fiduciary arrangements between an investment company and its investment adviser or principal underwriter are not assignable but also that in the event of an assignment, the fiduciary relationships themselves are automatically terminated. This policy is buttressed by the broad definition of "assignment" under Section 2 (a) (4)

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[54] In the instant case net asset value of the ISI stock was $1.81 per share against the purchase price of $50 per share. *Cf. Perlman* v. *Feldmann*, *supra*, in which the book value of the Newport Steel stock was $17 per share as against the purchase price of $20.

*Cf. Young* v. *Higbee Co.*, 324 U. S. 204 (1945), discussed p. 63, *supra*, where, since the stock was purchased not for its investment value but for the surrender by the sellers of their strategic position in the reorganization, the purchase price was $115,000 as against a value of $17,000.

in order to encompass transactions which otherwise might not have been reached under Section 15 alone. It has been said that "in the increasing complexities of modern business relations equitable remedies have necessarily and steadily been expanded, and no inflexible rule has been permitted to circumscribe them."[55] The same sense of accommodation should prevail in the interpretation of Section 36, especially since the matter in issue arises under a regulatory statute enacted by the Congress for the protection of investors and in the public interest, lest a grudging enforcement of the statute mark the beginning of its frustration. As the court said in *Virginian Ry.* v. *System Federation No. 40,* 300 U. S. 515, 552 (1937): "Courts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved."

Provisions of a statute should be so construed as "to carry out in particular cases the generally expressed legislative policy", *SEC* v. *Joiner Leasing Corp.,* 320 U. S. 344, 350–51 (1943), and the Congress has expressly indicated that it be done under this Act. For example, Section 6 (c) authorizes the Commission to exempt any person or transaction from the provisions of the Act to the extent that such exemption, *inter alia,* is consistent with "the purposes fairly intended by the policy and provisions" of the Act. Section 17 (b) provides that on application the Commission may exempt transactions between a registered invest-

[55] *Union Pacific Railway Co.* v. *Chicago, etc., Railway Co.,* 163 U. S. 564, 600–601 (1895).

ment company and its affiliates on the basis of findings, among others, that "the proposed transaction is consistent with the general purposes" of the Act. The courts, no less than the Commission, are to be guided by this broad legislative gloss upon the Act. The task of applying the sanctions prescribed by Section 36 has been assigned to the courts, and in so doing the Congress intended, as in the case of other statutes, "to mobilize the judicial authority in carrying out the policies of the Act", *Central-Illinois Securities Corp.* v. *SEC,* 338 U. S. 96, 125 (1949). As already noted, the last sentence of Section 1 (b) expressly provides that *all* provisions of the Act be interpreted in accordance with "the policy and purposes" thereof.

**II. The voting provisions of Section 15 were not intended by Congress as a substitute for the broad equitable standards under Section 36 and the sanctions therein prescribed**

Though apparently assuming the fiduciary relationtionships between ISI and the Trust Fund, the court below states that "the Congress did not make the assignment of agreements between Service Company [ISI] and Trust Fund, a violation of the Act, thus subjecting the violator to any and all of the sanctions provided by the Act" (R. 148). But we are not urging that every transaction that is legally deemed an "assignment" is wrongful or a breach of trust under Section 36. A sale of a controlling stock interest in the corporate investment adviser or principal underwriter at net asset value, or a transfer of such control by gift without more, is proper, even though the advisory or underwriting agreement is thereby termi-

nated under Section 15. Likewise, the death of a partner having a majority interest in a partnership which renders investment advisory or underwriting services to an investment company terminates the contract automatically, even though no sale or transfer of the contract literally occurs. It is when the sale of control involves receipt of consideration for the succession to these fiduciary offices that in our view, the sale constitutes "gross misconduct" or "gross abuse of trust" under Section 36. Nor are we urging that "all" of the statutory sanctions be applied here, since actions under Section 36 are specifically limited to the civil remedies there prescribed. Whether or not the Congress intended "any" judicial sanctions, is, of course, the central question in the case.

It seems that the lower court's observations were merely preliminary to its affirmative ruling that Section 15 itself prescribed its own "specific remedy", namely, that the sale of stock control automatically terminates these agreements, "thus leaving it to investors of Trust Fund" to determine by a majority vote whether to enter into new agreements with ISI under different control or with some other service company (R. 149). We agree that such is the effect of Section 15. But we do not agree with the implications. The court interprets Section 15 as though it read in effect that an assignment or sale is proper if a majority of the investors approve it. This implies that the Congress, faced with the wide-spread abuses resulting from trading in management contracts, determined that, to deter their recurrence, the enforcement of

fiduciary standards under Section 36 was neither necessary nor appropriate.

Section 15, as we have seen, does not make the assignment of investment advisory and principal underwriting agreements conditional on approval by the prescribed statutory vote.[56] The regulatory pattern is quite different and the underlying policy more strict. Sections 15 (a) (4) and 15 (b) (2) state respectively that it is unlawful to render investment advisory and principal underwriting services except pursuant to a written contract which must provide that they shall terminate "automatically" in the event of their assignment. Existing contracts, therefore, cannot be assigned with or without approval of investors. If they are assigned, not only is the assignment ineffectual but the underlying contractual arrangements for these services are thereby terminated. Pending the execution of new contracts and their approval by the vote required under Section 15, it is unlawful to perform these services except pursuant to an exemption (see pp. 78–79, *infra*).

There is no basis for assuming that the Congress intended Section 15 to preempt this vital and sensitive area of regulation to the exclusion of Section 36. While Sections 15 and 36 both assume the fiduciary status of the investment adviser and the principal underwriter, they are concerned with different, though related, aspects of that relationship. When

[56] We do not, however, wish to imply that if the statutory provisions against assignment were so conditioned, the management could make the assignment under circumstances which would involve the sale of the fiduciary office in contravention of equitable principles. See note 60, *infra*, and accompanying text.

stock control of the investment adviser or principal underwriter is sold and the contracts are thereby terminated, statutory approval of any new contracts is required under Section 15, while Section 36 focuses attention upon the fiduciary obligations of those who sell such control. To the extent that in a particular situation they traverse common ground and may affect respectively the purchasing and selling ends of the same transaction, Sections 15 and 36 should be read not in a spirit of antagonism and exclusion but in terms of harmony and mutual support, so that the policy of the Congress against trading in advisory and underwriting contracts may be fully attained. In *United States* v. *Boisedore's Heirs,* 8 How. (U. S.) 113, 121 (1850), the court said: "In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." [57] Words are even denied their literal meaning if to accept them literally would produce a result at variance with the legislative policy and purpose.[58] In this case, of course, it is sufficient that the words in the Act be given their natural meaning and intended purpose. For it is well within the bounds of literal consistency, and certainly in furtherance of the legislative purpose, to provide, on the one hand, that those seeking to assume the position of investment adviser or principal underwriter must secure the approval

[57] Quoted in *Mastro Plastic Corp.* v. *NLRB*, 350 U. S. 270, 285 (1955).

[58] *United States* v. *Rosenblum Truck Lines*, 31[illegible] U. S. 50, 55–56 (1941); *Commissioner* v. *Sternberger Estate*, 348 U. S. 187, 206 (1954).

required by Section 15; and, on the other hand, to prescribe that those who relinquish control shall be removed from any position of trust pursuant to Section 36, if they exploit the occasion for their self-enrichment.

Since, as we have seen, one of the basic purposes of the Act was to strengthen and raise the level of fiduciary obligations, not to weaken or lower it, Section 15 cannot be construed as a legislative writ of absolution from any of these obligations. In enacting Section 15, the Congress determined in effect that, because of their endemic relationship to the investment company, the investment adviser and the principal underwriter must be regarded in effect as members of the management complement, and that, as such, they must stand initially and annually thereafter for election by a majority vote of the investors or of their board of directors.[59] Accordingly, like directors and officers, they must assume the responsibilities essential to their fiduciary station and the restraints appropriate to their high office. Were a director of a registered investment company to engage in a transaction which involved a sale of his office, he would be subject to removal under Section 36 from any other fiduciary position therein indicated, including that of investment adviser or principal underwriter. It can hardly be contended that the result is any different if the transaction involves or is related to the office of investment adviser or principal underwriter itself. On the contrary, the wide-spread abuses disclosed in the investigation and

[59] See discussion of Section 15, pp. 39–44, *supra*.

the strong policy in Section 15 against assignment as defined in Section 2 (a) (4) require that such transactions be considered "gross misconduct" or "gross abuse of trust" under Section 36.

The construction of Section 36 as urged herein does not in any way detract from the authority conferred upon investors by Section 15. In casting their vote under Section 15 investors are not called upon to approve or disapprove the sale of the stock control, or to extenuate or to condemn any wrongful conduct in which those who sold control may have engaged. They vote only on whether to enter into a new contract with the successor persons in control. The statutory responsibility for invoking and enforcing the sanctions under Section 36 has been entrusted to the Commission and the courts, not to the investors.

The sanctions therein provided are of such central importance that the effect of an injunction under Section 36 is not limited to the particular investment company in respect of which the offense was committed. Under Section 9 (a) (2), a fiduciary enjoined under Section 36 is barred and disqualified from acting as an investment adviser, principal underwriter and in other fiduciary capacities with respect to *all* registered investment companies, unless, as provided by Section 9 (b), the Commission grants an exemption therefrom. Since the removal of a faithless fiduciary and its statutory consequences have been enacted in the public interest and for the protection of investors, these remedial provisions and the Commission's obligation thereunder cannot be vetoed or waived by a vote or the consent of investors. See *Medo Photo*

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*Supply Corp.* v. *NLRB,* 321 U. S. 678, 687 (1944); *Brooklyn Savings Bank* v. *O'Neil,* 324 U. S. 697, 704–706, 712–713 (1945). *Cf. National Licorice Co.* v. *NLRB,* 309 U. S. 350, 360 (1940).[60] If investors cannot do so by a vote specifically solicited or procured for that purpose, there is even less reason for reading such a result into Section 15, which, as we have seen, does not contemplate or call for a vote of exoneration. Section 15, we submit, underscores the fiduciary position of the investment adviser and principal underwriter. It does not release them from any responsibilities and restraints imposed upon them as a consequence of their fiduciary status.

It may be noted that a similar approach and policy were expressed by the Congress in Section 25 of the Act relating to reorganizations of registered investment companies. Such reorganizations often require a vote of stockholders under local law. Solicitation

[60] In *Medo Supply Corp.* v. *NLRB*, 321 U. S. at 687, the court said: "The statute was enacted in the public interest for the protection of the employees' right to collective bargaining and it may not be ignored by the employer, even though the employees consent, *Labor Board* v. *Newport News Co.*, 308 U. S. 241, 251, or the employees suggest the conduct found to be an unfair labor practice, *National Licorice Co.* v. *Labor Board*, *supra*, 353, at least where the employer is in a position to secure any advantage from these practices, *H. J. Heinz Co.* v. *Labor Board*, 311 U. S. 514, 519–521, and cases cited."

*Cf.* Section 47 (a) of the Investment Company Act which provides that, "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void."

Even where a statute does not have an anti-waiver provision, courts will invalidate the waiver if to permit it would thwart the legislative policy. See *Brooklyn Savings Bank* v. *O'Neil*, 324 U. S. 697, 713 (1945), and cases there cited.

of proxies with respect to plans of reorganization are subject to Commission scrutiny under Section 25 (a). Under Section 25 (b) the Commission is authorized to prepare an advisory report on the plan at the request of holders of 25% of any class of the outstanding securities, and the investment company is required to mail a copy of such report to all security holders affected by the plan. Nevertheless, whether or not the plan is approved by the security holders, the Commission, under Section 25 (c), may obtain an injunction against the consummation of the plan if the court determines the plan to be "grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan." Similarly, certain transactions between a registered company and its affiliate are prohibited under Section 17 (a) unless an exemption is obtained under Section 17 (b). The grant of the exemption is conditioned on a finding by the Commission, *inter alia,* that the proposed transaction is fair and "consistent with the general purposes" of the Act. The Commission rejected a construction which "would, in effect, make a vote of security holders a substitute for review under Section 17 (b)." *E. I. Du Pont de Nemours & Co.,* 34 SEC 530, 534 (1953).[61]

That the Congress did not declare in *haec verba* the

[61] *Cf. Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 127–129 (1939), in which the court held that in bankruptcy reorganization, judicial authority for determining whether a plan is fair and equitable cannot be abrogated merely because a majority of the security holders affected by the plan have consented to it.

sale of the succession to the office of investment adviser or principal underwriter to constitute a breach of trust, is not significant. The very words "gross abuse of trust" connote fiduciary standards and obligations. Since Congress declared that these fiduciary offices were not objects of sale and that aspirants to such offices were subject to election, payment to the present management or those in control for the succession is forbidden under equitable doctrines which courts of equity have enforced for at least one-hundred years, and of which, we may be sure, the Congress was aware when it enacted the broad and inclusive provisions of Sections 15 and 36. These equitable principles were discussed in the Commission's report of investigation with specific reference to the transfer of management contracts.[62] Similar views were expressed by certain spokesmen for investment companies. Mr. Merrill Griswold, then and for many years later, chairman of the board of Massachusetts Investors Trust, the largest of the open-end companies, referring to the evils resulting from the sale of control, indicated that this practice might not be prevalent with respect to such investment trusts as are under no management contract but are managed by trustees who own only a small amount of the widely-held stock of the investment trust. He then continued:

> It has been suggested that the trustees might sell out their office—in other words, that you could come to me and offer me so much money, and that I would resign, and the other trustees would elect, we shall say, Mr. De Ronde to take

[62] See SEC Report, note 15, *supra*, pp. 1029, 1086.

> my place, and then another one of us would resign and we would elect some other man; and in that way we could sell out.
>
> The answer to that is that it is absolutely impossible for us to do that; because under the common law respecting fiduciaries, if we were crooked enough to do it, the funds we would receive would themselves belong to the company, and we could not keep them; and if we did keep them, we would be guilty of an embezzlement. In other words, we cannot "sell down the river" if we want to—and we do not want to.[63]

Likewise, Mr. Hugh W. Long, then president of New York Stocks, Inc., also an open-end company, stated with specific reference to Section 15:

> At the outset, let me say that we approve without reservation those provisions of Section 15 which require that the compensation of management be precisely defined and which provide for the cancellation of management and distributing contracts upon assignment of a contract or transfer of control of the company holding it. We quite agree that there should be no opportunity for investment companies to be "sold down the river." Although the transfer of a personal-service contract of a fiduciary nature is probably a violation of ordinary rules of law, we see no objection to a specific prohibition in this statute.[64]

In short, Section 15 itself, broadly speaking, was looked upon as affirming and amplifying basic fidu-

[63] Hearings before the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), p. 505.

[64] Hearings, etc., note 63, *supra*, p. 585.

ciary law and not as a surrogate for the historic trust obligations prescribed by courts of equity.

An illuminating illustration of the principle as applied under the Act was before the Commission in an uncontested case several years ago. The case involved Management Associates which performed investment advisory and other management services for Incorporated Investors, a registered open-end company.[65] Management Associates had 6,000 shares outstanding of which William Tudor Gardiner held 3,000 shares.[66] Upon his death these shares passed to his estate. It was assumed, without a formal determination, that this transfer constituted an "assignment" which terminated the advisory contract. Since a new agreement required approval of investors under Section 15 (a), a temporary arrangement for the continuation of the advisory services was made. Thereupon an application for an exemption for such continuance from Section 15 was filed with the Commission pursuant to Section 6 (c), pending a definitive disposition of the 3,000 shares by Gardiner's executors and a subsequent submission of a new advisory contract for approval by the investors of Incorporated Investors. That application was granted, *Incorporated Investors,* Investment Company Act Release No. 1911 (1953). The temporary exemption was thereafter extended on application which, as stated in the Commission's or-

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[65] As of September 30, 1956, Incorporated Investors had net assets of about $249,000,000. See Appendix B, p. 1, *infra.*

[66] The public files of the Commission show that the other remaining shares were then held by three other officers of Incorporated Investors as follows: 1,800 shares by William A. Parker, and 600 each by Amory Parker and George D. Aldrich.

der, contemplated the sale of the 3,000 shares to Management Associates, *Incorporated Investors,* Investment Company Act Release No. 1947 (1954). It further stated: "As consideration for the 3,000 shares of Management Associates' stock, Gardiner's estate will receive a cash payment equal to the value of one-half of the net assets of Management Associates, as shown by the books as of November 30, 1953. The assets as shown by the books comprise certain tangibles, receivables and cash, but no amount of any goodwill or contracts accrued by Management Associates."[67] In other words, for the 50% stock interest in the investment adviser, the executor neither sought nor received any payment because of the investment advisory relationship with the investment company. The parties and the Commission agreed that, since the contract is nonassignable, no value may properly be attributed to it for the benefit of the selling stockholder or his estate.

The narrow interpretation of Section 36 adopted by the court below may result in the recurrence of the

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[67] Thereafter a new contract was approved by the shareholders of Incorporated Investors at a meeting held on March 24, 1954. The proxy statement apprised shareholders of the sale of the stock by the Gardiner estate to Management Associates and the proposed resale by Management Associates of part of the reacquired shares to two of its stockholders and the contemplated resale of additional shares to the president of Incorporated Investors. Subsequently Management Associates was liquidated into Parker Corporation which previously was the principal underwriter for Incorporated Investors.

Parker Corporation now is investment adviser and principal underwriter for Incorporated Investors. Its outstanding 6,000 shares are held by four stockholders. See Appendix B, p. 1, *infra*.

very abuses that the Act was designed to avoid. If the sale of stock control by the existing management at any price is beyond the reach of the statute, control may well be put on the auction block and sold to the highest bidder for the benefit of the management. No thought is likely to be given by those in control to use the occasion of the sale for improving the position of investors through more advantageous investment advisory or underwriting contracts with the successors, although under Section 15 the selection of the new adviser or underwriter is within the power and authority of the public investors. Moreover, those purchasing control may be tempted to pursue hazardous or doubtful policies in order to recoup as quickly as possible the substantial price they paid for control. In the instant case, the purchasers paid over $4,000,000 in excess of the net asset value of the ISI stock (R. 8–9); and their estimates indicate a ten-year recoupment period at 4% interest (R. 112–115). We are not suggesting that the new controlling interests in ISI will abuse their fiduciary position with respect to the Trust Fund. But Sections 15 and 36 and the policies upon which they are based were designed to prevent such and other kindred abuses from again becoming a reality. It is immaterial whether in a particular situation such abuses may or may not be present. See *North American Co.* v. *SEC,* 327 U. S. 686, 710–711 (1946).

The intimation by the court below (R. 149) that, given the right to elect their investment adviser and principal underwriter, investors would overcome their inertia and mobilize in protest against those who

pay for the succession to these contracts, seems to us implausible and unrealistic. If the court below is sustained in its view that such transactions are proper and valid, it is not likely that the investors would undertake to oppose an entrenched management which legally or *de facto* is committed to further the interests of the successful bidder. Indeed, with the legality of these transactions no longer subject to question, the investors' trust and confidence in the old management, established over the years, will prove a weighty, and probably the controlling factor, in favor of its nominee or successor. Moreover, with respect to open-end companies, such as the Trust Fund in the instant case, whose securities are redeemable at net asset value, investors, who are not satisfied with the proposed successor, probably will exercise their right of redemption rather than engage in a contest against what may appear to them as hopeless odds.

Nor, by the same token, will prospective purchasers be deterred from paying substantial amounts for the succession to the advisory and underwriting services, as, indeed, this very case illustrates. For it would be naive to assume that the purchasers in this case were investing over $4,000,000 in excess of the book value of the ISI stock, without the anticipated agreements with the Trust Fund or with indifferent feelings as to these agreements. It is equally naive to suppose that the purchasers would undertake this substantial investment with any actual apprehension that the outcome of the statutory vote might be in precarious balance, or that, on urging by investors, competing service agencies might intercede to wrest the proposed

new agreements from ISI. The real concern of both sellers and buyers, as the record amply demonstrates (R. 117–135), was over the sanctions prescribed by Section 36 in the light of the Commission's published interpretation of that Section as early as 1942 (R. 124–128).

The fact that, in the purchase contract for the third installment of 16,000 shares of ISI stock at an aggregate price of $800,000, it was stipulated that this purchase was not conditioned on investor approval of the advisory or underwriting agreements with the Trust Fund (R. 66–68), does not suggest the purchasers' indifference to these agreements but rather that they entertained no apprehension regarding a favorable vote of the investors. Without pressing the point at this juncture, we suggest that this stipulation, and other devices, such as the staggering of the sale of the ISI stock in lots of less than 25% and insistence that the distribution of the stock also be so limited (R. 67, 110), were staged to give the transactions the surface appearance of stock sales. In the present context these maneuvers appear to have been undertaken in the hope or expectation that the Commission or the courts might resolve the issue under Section 36 for their benefit in terms of fiction rather than the actualities of the transactions. Needless to say, if the views of the court below should prevail, trading in these fiduciary arrangements will be more forthright, unencumbered by the stage props which the parties felt constrained to employ in this case.

In adverting to these practical considerations and consequences, we do not, of course, lose sight of the

fact that we are concerned here with a remedial statute and, more particularly, with a legislative determination to extirpate the baneful trafficking in fiduciary contracts, the results of which had brought grief and disaster to public investors. To the extent that the Act now provides investors with the means of denying the benefits of these contracts to successor interests for cause or otherwise, this is all to the good, and our construction of Sections 15 and 36 does not foreclose or affect these salutary avenues of self-help. But it stands to reason that in dealing with this problem the Congress intended to adopt measures equal to the task and purpose, so that the protection against these pernicious practices shall extend to all investors under all contingencies. The effectiveness of the prescribed remedies cannot be circumstantial, depending upon whether public investors are alert or inarticulate, suspicious or trusting, well-organized or diffused. Courts of equity have not withheld relief for breach of trust merely because, by effective organization and intelligent use of their voting rights, security holders could displace a management not to their liking. In response to the growing complexities of corporate life, courts of equity have exercised greater vigilance in the enforcement of fiduciary responsibilities, *Ashman* v. *Miller*, 101 F. 2d 85, 91 (C. A. 6, 1939); [68] and equita-

[68] The court said: "The growth of corporations and the disappearance of the individual and partnership forms of business have become so extensive and vital in our economic life, and so many artificial legal devices have been set up which serve to isolate the stockholder from control over his investment that directors and other officers of a corporation should be held to a strict accountability for their acts in its management."

ble remedies have been correspondingly expanded to meet these developments, *Union Pacific Railway Co.* v. *Chicago, etc., Railway Co.,* 163 U. S. 564, 600–601 (1895) (quoted page 67, *supra*). The same degree of vigilance and perception should be credited to the Congress, when it directed the courts to enforce fiduciary standards under Section 36.

The court below concluded that the Congress intended Section 36 to have a limited effect and stated that this was "evidenced by the fact that Section 36, when first considered by the Congress, applied to misconduct and abuse of trust *generally*" (R. 148) (italics in original).[69] The court's footnote reference is to S. 3580, 76th Cong., 3d Sess., introduced by Senator Wagner on March 14, 1940. In our view, a reading of this bill and the subsequent changes indicate a contrary intent.

The predecessor provision to Section 36 of the Act was Section 17 (e) of S. 3580 which read as follows:

> Any gross misconduct or gross abuse of trust in respect of a registered investment company, on the part of any person registered under Section 9 as an affiliated person of or principal underwriter for such company, shall be unlawful.

Section 9 (a) of the bill then provided that, unless registered with the Commission, it was unlawful for any person to act as officer, director, manager, investment adviser or depositor of a registered investment company or as principal underwriter for a registered open-end investment company. The grounds for denying or revoking registration were set forth in Sec-

[69] The italics appear in the court's slip opinion and in 146 F. Supp. at 780.

tion 9 (d).[70] The word "generally" was not included, nor were its implications suggested, in the bill. Under S. 3580, as well as under Section 36 of the Act the gist of the wrong was "gross misconduct or gross

[70] Section 9 (a) of S. 3850 provided:

"It shall be unlawful for any person, unless registered under this section, to serve or act in any of the following capacities for a period exceeding sixty days:

"(1) as officers, director, manager, or investment adviser of or for a registered management investment company or registered face-amount certificate company;

"(2) as depositor, manager, or investment adviser of or for a registered unit investment trust;

"(3) as principal underwriter for a registered open-end management investment company, registered unit investment trust, or registered face-amount certificate company; or

"(4) as a distributor who makes use of the mails or any means or instrumentality of interstate commerce to engage in the business of selling periodic payment plan certificates, or as a salesman for such a distributor."

Section 9 (d) (1) and (2) of S. 3850 provided:

"The Commission shall by order deny registration to, or revoke or suspend the registration of, an applicant under this section, if the Commission finds that such denial, revocation, or suspension is in the public interest and that—

"(1) the applicant, within ten years of the issuance of such order, has been convicted of any felony or misdemeanor involving the purchase or sale of any security, or arising out of the applicant's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company;

"(2) the applicant, at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security."

abuse of trust in respect of a registered investment company," and investment advisers and principal underwriters were made subject to the sanctions therein prescribed. While the provisions for registration were not adopted, the grounds for denying or revoking registration of officers, directors, investment advisers, etc., under Sections 9 (d) (1) and (2) of S. 3580 are now included, as we have seen, as automatic bars and disqualifications under Section 9 (a) (1) and (2) of the Act.

The purpose of Section 17 (e) of S. 3580 was thus explained by counsel for the Commission: [71]

> "Subsection (e) of Section 17 attempts to set forth a broad standard of conduct.
>
> "You made a suggestion originally, Senator Taft, to this effect: Why can you not set forth in this bill a fiduciary obligation and make it a crime to violate that fiduciary obligation?
>
> "When we came to draft a provision like that it presented a great many problems, because if you try to impose a trustee obligation on these managers, maybe that obligation is much too strict. A trustee in some instances may be liable for negligence. We felt that that was possibly too onerous an obligation to impose upon people who are managing investment companies. So we took the broader approach and said that if he was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime.
>
> "Of course that does not mean that the Securities and Exchange Commission has the jurisdiction to determine whether he has been guilty

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[71] Hearings before Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), p. 262.

> of gross abuse or gross misconduct, or gross abuse of trust. That is a criminal offense, and criminal action would have to be instituted against him."

An industry spokesman objected to this provision because by making such conduct "unlawful," it subjected persons to criminal penalties "for violation of an indefinite standard which was impossible of determination."[72] By compromise this provision was recast as Section 36; and only civil sanctions were imposed for "gross misconduct or gross abuse of trust." As part of this compromise there was also included Section 37 of the Act which makes "unlawful" theft, embezzlement or conversion of "funds, securities, credits, property, or assets of any registered investment company."

It is clear from the foregoing that, except for the criminal implications in the bill, there was no basic disagreement on the substance of Section 36 or its predecessor. Only the criminal sanctions were narrowed and limited, so that a transaction constituting gross misconduct or gross abuse of trust under Section 36 is subject to criminal prosecution only if it is an "unlawful" act under the limited provisions of Section 37, which, of course, applies to all persons. Needless to say, when Section 36 was limited to a remedy for injunction, the term "unlawful" was obviously unnecessary in its civil setting. In short, since the critical language of the bill was retained in the final text, the same breadth and scope must be attrib-

[72] Hearings before House Committee on Interstate and Foreign Commerce on H. R. 10065, 76th Cong., 3d Sess. (1940), p. 124.

uted to Section 36. As we have seen, the policy under Section 15 and historic equitable principles embodied in Section 36 so require.

Finally, appellees also argued below that no stock control was sold or transferred. They urged that Section 2 (a) (4), which refers to a transfer of a "controlling block" of securities, must be interpreted in the light of Section 2 (a) (9). Under this Section "control" means "the power to exercise a controlling influence over the management or policies of a company", and a presumption of control arises as to "any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company * * *". Appellees stated that each of the director-defendants held 18.2% of the outstanding ISI stock; that none of the purchasers owns or holds 25%; and that, accordingly, there was no sale or purchase of control.

It is readily evident from Section 2 (a) (9) that in any relevant transaction control is not necessarily dependent on stock ownership or on any particular percentage of stock. In connection with stock, 25% or more of the voting stock is deemed to constitute presumptive control. The Commission's complaint alleges that, "On or about February 1, 1956, the director-defendants either alone or in concert with others, embarked upon a plan to sell their stock interests to a small number of purchasers, affiliated among each other through stock ownership and otherwise" (R. 8). As further alleged in the complaint (R. 8–9), from February to July 1956, the director-defendants, pursuant to the plan, sold 68,000 shares of ISI stock, or about

40.8% of the total outstanding, while 13% was sold by other stockholders acting in concert with them. We submit that if Section 36 applies when one person transfers control by a sale of more than 25% of the stock, it is equally applicable when control is transferred by a group of persons in the same aggregate amount pursuant to a plan. The possibilities for evading the statute if it were construed otherwise are too obvious to require further discussion. In *Pepper* v. *Litton,* 308 U. S. 295, 312 (1939), the court said:

> No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

Appellees also denied that such a plan existed, and submitted affidavits in support of that contention (R. 55–58). The Commission filed counteraffidavits, (R. 104–123, 128–134), and the evidence thus far obtained, and as elsewhere summarized (pp. 7–10, *supra*), strongly supports the Commission's allegations that the transactions were executed pursuant to a plan. In any event, the proper method of raising these factual issues is by answer, not by a motion to dismiss or for summary judgment.[73] The court below said that it

[73] In their memorandum below, appellees stated in the alternative that their motion be considered as one for summary judgment under Rule 56 of the Federal Rules of Civil Procedure.

was "a very difficult thing to reach that sort of question on a motion to dismiss or even on a motion for summary judgment." (R. 160), and based its decision on the assumption that there was a sale of control within the meaning of the statute (R. 146–147).

The refusal of the court below to resolve these factual questions on motion is in accord with this Court's ruling in *Lane Bryant, Inc.* v. *Maternity Lane, Ltd.*, 173 F. 2d 559, 565 (C. A. 9, 1949):

> The affidavits upon their broadest application do no more than to present to the trier of fact evidence upon material issues. They do not absolve the issues as matters of law. Therefore, the judgment cannot validly be based upon the summary trial by affidavits. The plaintiff-appellant is entitled to have its complaint responded to by answer and both parties are entitled to have the issues tried through the introduction of exhibits and witnesses produced for direct and cross examination.

A summary disposition on motion is particularly inappropriate here since the relevant facts are within the peculiar knowledge of the appellees and the purchasers. As the court said in *Toebelman* v. *Missouri-Kansas Pipe Line Co.* 130 F. 2d 1016, 1022 (C. A. 3, 1942):

> It is obvious that this evidence must come largely from the defendants. This case illustrates the danger of founding a judgment in favor of one party upon his own version of facts within his sole knowledge as set forth in affidavits prepared ex parte. Cross-examination of the party and a reasonable examination of his records by the other party frequently

> bring forth further facts which place a very different light upon the picture.

In such circumstances, even in the absence of counter-affidavits, the courts will not regard the matters set forth in the moving affidavits as admitted by the opposing party. See *Subin* v. *Goldsmith,* 224 F. 2d 753, 758–761 (C. A. 2, 1955), certiorari denied, 350 U. S. 883 (1955). Although appellees, at our request, have voluntarily furnished to us some documents, they do not appear to us complete, and, indeed, call for further inquiry, including examination and cross-examination of witnesses, so that the factual issues can be properly resolved by the court after answer and trial.

**III. ISI and the director-defendants are persons subject to the sanctions of Section 36**

Appellees argued below that, even if the transactions come within Section 36, ISI and the individual defendants are not persons within its interdiction. Section 36 applies to any "person"[74] who acts or serves as an "officer, director * * * investment adviser, or depositor" of any registered investment company, or as "principal underwriter" for an "open-end company." ISI is, of course, the investment adviser, depositor and principal underwriter for the Trust Fund, an open-end company. Appellees conceded, *arguendo,* that it would be wrong for ISI to sell its fiduciary position as investment adviser or principal underwriter, or for directors of the Trust Fund to do likewise with respect to their office. But,

[74] Section 2 (a) (27) defines a "person" as including a company.

they urged, the alleged misdeeds in this case were not committed by ISI but by its directors and controlling stockholders, while the director-defendants, the authors of the offending transactions, are not directors, officers, etc., of the Trust Fund, the investment company, but rather of ISI. Appellees' contention in effect is that immunity from Section 36 can readily be obtained, if the investment advisory and principal underwriting functions of the Trust Fund are performed by them through a separate corporation such as ISI, and the sale of the succession is effected by a sale of stock control of ISI. The court below, having determined that no wrongful act was committed under Section 36, did not reach this question. It did indicate, however, that if the transactions constituted gross misconduct or gross abuse of trust in respect of the Trust Fund, Section 36 would apply to appellees (R. 157–158). In anticipation that it will be argued by appellees to this Court, this question is briefed here.

In our view, the policy of the Congress against trading in investment advisory or principal underwriting contracts, and the related fiduciary standards and sanctions under Section 36, cannot be evaded as a consequence of incorporation. Investment advisory and principal underwriting services, as we have seen (pp. 49–52, *supra*) are essentially management functions, which the individual defendants through ISI are obliged to perform on behalf of the Trust Fund. Investors who purchased Participation Agreements in the Trust Fund did not put their faith and trust in an abstract corporate entity but in the professional

managers and in the direction and know-how they have undertaken to furnish to the investors. If, for convenience or other reasons, they wish to pool their individual skills in the form of a corporation, it is their privilege to do so. But, in exercising this privilege, they, surely, did not intend or expect to divert the investors' reliance to the corporate abstraction. The basic appeal to investors rests, as always, upon their personal capacities and qualifications; and their self-assumed fiduciary obligations, which run, directly or through ISI, to the Trust Fund and its investors, necessarily remain the same. In this case, indeed, these obligations are further accentuated and multiplied, since, when the wrongful transactions were executed, and for years prior thereto, ISI has had—and still has—no other business; the Trust Fund has had no other management except ISI; and the individual defendants were directors and officers and also controlling stockholders of ISI.[75]

Public policy against trading in fiduciary contracts and the corresponding sanctions under Section 36 are too firm and exacting to yield to the *tour de force* which appellees contrived here. Had the individuals involved in this case been content to act as investment advisers or principal underwriters of the Trust Fund

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[75] See *Perlman* v. *Feldmann*, 219 F. 2d 173, 178 (C. A. 2, 1955), certiorari denied, 349 U. S. 952 (1955), wherein Feldmann, the principal defendant, was the president, chairman of the board of directors and the dominant stockholder, the court said: "In this case the violation of duty seems to be all the clearer because of this triple role in which Feldmann appears, though we are unwilling to say, and are not to be understood as saying, that we should accept a lesser obligation for any one of his roles alone."

directly, it is conceded, *arguendo,* that they could not have sold the succession to their position without incurring the sanctions prescribed by Section 36. They cannot escape the statutory consequences if they commit the wrongful act indirectly, merely because they have chosen to discharge their commitments to the Trust Fund through ISI or because they have assumed the titular positions of directors and officers of ISI rather than of the Trust Fund. Accordingly, when Section 36 directs the removal of the investment adviser or principal underwriter for gross misconduct or gross abuse of trust, it is immaterial whether the offending transaction against the Trust Fund is committed by the ostensible or official occupants of these positions or by those who manage and dominate the investment adviser or principal underwriter. See *Ashman* v. *Miller,* 101 F. 2d 85, 91 (C. A. 6, 1939), quoted note 68, *supra; Ripperger* v. *Allyn,* 25 F. Supp. 554, 555 (S. D. N. Y. 1938), quoted note 81, *infra.*[76] By the same token the court whose jurisdiction is invoked under Section 36 may require that those initiating the wrongful acts should account for the benefits derived as a consequence of the breach of trust.[77] This construction of the statute is clearly es-

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[76] *Cf. Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492 (1919), where the court said: "It is the fact of control of the common property held and exercised, not the particular means by which or the manner in which the control is exercised, that creates the fiduciary obligation."

[77] See *Aldred Investment Co.* v. *SEC*, 151 F. 2d 254, 261 (C. A. 1, 1945), certiorari denied, 326 U. S. 795 (1946), where the court said: "Section 36 invokes the equity power of the Federal Court and that calls into play its inherent powers where necessary to do justice and grant full relief."

sential, if Sections 15 and 36 are to fulfill the purposes that the Congress intended, while the alternative of complete immunity for which appellees argue provides a ready means for evading the statutory policy.[78]

We reach the same conclusion under equitable principles and under the statute if the problem is approached from the point of view of ISI's own particular relationship to the Trust Fund and its public investors. It is familiar doctrine that one who, not otherwise under any fiduciary obligation, participates in the commission of a breach of trust, is liable for the consequences of the breach. See *Jackson* v. *Smith,* 254 U. S. 586 (1921). Liability is also imposed upon a fiduciary who condones activities, detrimental to the trust, committed by those employed to assist the fiduciary in managing the trust estate. See *Mosser* v. *Darrow,* 341 U. S. 267 (1951), where in holding the trustee liable for the profits realized by his subordinates as a result of their trading in the capital stock of the corporation's subsidiaries, the court said (341 U. S. at 272): "We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself." In a word, to courts of equity the trust obligation is not only personal but

[78] *Cf.* Section 48 (a), subtitled "Liability of Controlling Persons: * * *", which makes it unlawful "for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do" under the Act.

also vicarious, and the same basic principles apply here.

ISI has no proprietary interest in its investment advisory and principal underwriting relationships to the Trust Fund. Its services are essentially of a fiduciary character, and, as trustee, ISI may continue to render these services, under the voting procedures set forth in Section 15, only for the purpose of discharging its obligations to the Trust Fund, and for no other. The sale of its fiduciary position is not one of the prerogatives attached to its office. In fact, the practice is contrary to the policy and provisions of Section 15, and equitable principles forbid it. Since ISI, in its corporate capacity, may not engage in such transaction, its directors and officers cannot sell ISI's fiduciary office for their own benefit as majority stockholders. From the point of view of the Trust Fund and its investors, the dangers inherent in the trading of ISI's fiduciary relationships are precisely the same, whether such trading is endorsed or undertaken by every member of the corporate body or by the controlling and managing organs of the corporation.

If, as a practical matter, ISI could not prevent the transaction or seek an accounting for the benefit of the Trust Fund, neither could it withhold its official consent, had such consent been sought by the director-defendants and the other participants in the sale. It should be recalled that prior to the first transaction in the ISI stock in February 1956, ISI had nine stockholders (R. 7–8), and that eight of these participated in the sales (R. 9, 56–59). The nonpartici-

pating stockholder is the owner of only 6/10 of one percent of the outstanding ISI stock (R. 8, 9). If we look at the composition of ISI stockholders involved in all of the transactions between February and July of 1956, and up to the filing of the lawsuit, it is evident that, except for the same nonparticipant, all of them at one point or another were either sellers or direct purchasers from these sellers (R. 8–9, 56–59). To require formal corporate participation or consent as a condition precedent for imposing upon ISI the sanctions and liabilities under Section 36, when those in control and others have determined to engage in the stock transactions, is to rest on form and to abandon substance. Statutory policy and fiduciary standards cannot be thus administered and enforced.

The construction of Section 36, as urged herein, is required by the cognate provisions of Section 15 with respect to the consequences of an assignment. Section 15 (a) (4) requires that the investment advisory contract provide for its automatic termination in the event of "its assignment by the investment adviser." Section 15 (b) (2) prescribes similarly with respect to the contract of the principal underwriter for an open-end company in the event of "its assignment by such underwriter." Under the definition in Section 2 (a) (4), every assignment is included, "direct or indirect." As we have previously explained (pp. 43–44, *supra*), the Congress specifically envisioned that investment advisory and principal underwriting services might be performed by persons not only as individuals but also through a corporation. Having in mind that the character and quality of these fiduciary services

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may also be seriously affected by a sale of stock control, the Congress provided that an assignment by the corporate investment adviser or principal underwriter occurs also upon a transfer of "a controlling block of the assignor's outstanding voting securities by a security holder of the assignor." When thus read together, Sections 2 (a) (4) and 15 clearly treat the sale of a controlling stock interest in ISI as an indirect assignment of the contracts by ISI, even though formally these contracts were between ISI and the Trust Fund and the stock transactions were between ISI stockholders and third parties. When, in addition, the assignment involves a breach of trust, the imputation of the assignment to ISI is no less essential or mandatory.

A similar approach is expressed in Section 9 (a) (3) which makes it unlawful for a company to act as investment adviser or principal underwriter for a registered investment company, as therein specified, if an "affiliated person" of such company "is ineligible" to serve the investment company in any of the positions specified in Sections 9 (a) (1) and (2). This means, for example, that when a director, officer or a 5% stockholder engaged in any securities transaction which resulted in his criminal conviction within the past ten years or subjected him to a permanent or temporary injunction in connection therewith, the corporation is automatically disqualified as an investment adviser or principal underwriter for any investment company.

Section 9 (a) (3) thus represents a Congressional determination that the corporate fiduciary is not

permitted to remain in its position of trust if it retains within its organization an affiliated person involved in any wrongful securities transactions, the underlying assumption being that the retention of such person represents a danger to the investment company and its public security holders. Likewise, Section 36, within its specific context, cannot be construed in a manner that would provide immunity for the corporate investment adviser or principal underwriter when the persons in control have engaged in transactions which under Section 36 and applicable equitable principles constitute gross misconduct or gross abuse of trust in respect of the investment company.

The enforcement of fiduciary standards as urged herein is a particular application of a principle which courts have applied in the wider area of corporate law.[79] It is aptly illustrated in the leading case of *State ex rel. Attorney General* v. *Standard Oil Co.*, 49 Ohio St. 137, 30 N. E. 279 (1890). In that case holders of all but seven of the defendant corporation's outstanding shares transferred their shares to trustees who, pursuant to an agreement with these stockholders and others engaged in the same business as the defendant, combined to form a monopoly and to engage in restraint of trade. The court held that the combination was illegal and that, since as a consequence of the agreement the trustees dominated the affairs of the corporation, liability must be imposed upon the corporation. The court rejected the contention that the corporation had never authorized the

[79] See generally 1 Fletcher, *Corporations* § 42 (Perm. Ed. 1931).

arrangement and was not a party to it. It pointed out that the corporate fiction was a device of convenience which the courts will recognize only so long as the powers and privileges under corporate franchise are not abused and employed for unlawful purposes by the corporation or those in control. The court said (49 Ohio St. at 184, 30 N. E. at 289–290):

> It therefore follows * * * that where all, or a majority, of the stockholders comprising a corporation do an act which is designed to affect the property and business of the company, and which, through the control their numbers give them over the selection and conduct of the corporate agencies, does affect the property and business of the company, in the same manner as if it had been a formal resolution of its board of directors, and the act so done is *ultra vires* of the corporation and against public policy * * * the act should be regarded as the act of the corporation; * * * [80]

Moreover, we do not agree that the director-defendants of ISI were not also directors and officers of the Trust Fund when they sold their stock and when this suit was brought. Section 36 applies to a person who "serves or acts * * * as officer, director" of an investment company. Section 2 (a) (12) de-

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[80] The same principle was applied in a similar case where all the stockholders joined in the illegal agreement. *People* v. *North River Sugar Refining Co.*, 121 N. Y. 582, 24 N. E. 834 (1890). The court rejected the argument based on the separate corporate entity, saying that to accept it would mean that "while all that was human and could act had sinned, yet the impalpable entity had not acted at all, and must go free." *Cf. Majestic Co.* v. *Orpheum Circuit, Inc.*, 21 F. 2d 720, 724 (C. A. 8, 1927).

fines the term "director" as including not only a director of a corporation but also "any person performing similar functions with respect to any organization, whether incorporated or unincorporated * * *" In the instant case the Trust Fund had no separate management of its own, and all policy and management functions were performed by the director-defendants and their associates on the board of ISI. The prospectus of the Trust Fund specifically recognizes that. It states: "The Board of Directors of Insurance Securities, Incorporated is composed of eleven members. As the Trust Fund has no officers or Board of Directors, the officers and directors of Insurance Securities Incorporated render their services to the Trust Fund" (R. 111).[81]

We recognize that enforcement of Section 36, as urged here, would affect a minority interest in ISI not in complicity with the director-defendants. But it should be recalled that the stockholders of ISI, like ISI itself, have no vested or indefeasible interest in ISI's contracts with the Trust Fund. The right and privilege of designating the investment adviser and principal underwriter belong to the Trust Fund

[81] See *Ripperger* v. *Allyn*, 25 F. Supp. 554 (S. D. N. Y. 1938), where the court denied a motion to dismiss a bill in equity seeking an accounting from certain securities dealers for the profits derived from diverting to themselves an opportunity allegedly belonging to a corporation. The court said: "The security dealers were not directors of the corporation. But the charge is made that the directors always did their bidding and acted for their individual interests. If this is true, the security dealers were in fact the managers of the corporate affairs and stood in a fiduciary relationship to the corporation equivalent to that of directors and officers."

and its investors, not to the stockholders of ISI. Under Section 15 (a) (3) ISI's investment advisory contract must provide for its termination on 60 days' notice without penalty. ISI's investment advisory and principal underwriting contracts with the Trust Fund must be renewed by investors of the Trust Fund or the Trust Fund's own board of directors under Section 15, as the case may be, and come to an end if not so renewed. The sale of stock control of ISI terminates these contracts, and a minority stockholder cannot complain if, as a consequence, new contracts should be made with someone other than ISI. When the sale of control of ISI is effected under circumstances involving also a breach of trust, as in this case, a minority stockholder of ISI cannot object in this action, if as a result of such termination and a court decree under Section 36, ISI is precluded from competing with other servicing agencies for new contracts with the Trust Fund. Accordingly, his minority interest in ISI and his expectations, subject as they are to these statutory contingencies, do not justify withholding the relief prescribed by Section 36.

Moreover, the remedies which may be applied under Section 36 are not fixed or rigid. Under Section 36, the court, as a court of equity, has the power to grant such equitable relief as in the light of all the facts appears appropriate and consistent with the statutory purpose.[82] There is no reason for assuming

[82] It was expressly so held in *Aldred Investment Co.* v. *SEC* 151 F. 2d 254, 260–261 (C. A. 1, 1945), certiorari denied, 32[illegible] U. S. 795 (1946). See also *Bailey* v. *Proctor*, 166 F. 2d 39[illegible] (C. A. 1, 1948).

that, after trial, the court will impose all permissible sanctions under Section 36 regardless of the interest of investors in the Trust Fund.[83] Obviously, the court will consider all relevant circumstances. In the present posture of the case it is premature to determine the scope of relief that may be necessary and appropriate; and the Commission's request for relief in its amended complaint (R. 14–15, 47–48) is in accord with the provisions of Section 36 and the equitable powers of the court thereunder.

### IV. The amended complaint states a cause of action under Rule X-14A-9 of the Commission's Proxy Rules

Section 20 (a) of the Act in substance makes it unlawful to solicit proxies in respect of a security of a registered investment company "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate * * * for the protection of investors." Rule N-20A-1, promulgated under the Act, makes applicable the Proxy Rules adopted by the Commission under Section 14 (a) of the Securities Exchange Act of 1934. The relevant provision here is Rule X-14A-9 which states:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communi-

[83] *Cf.* Section 9 (b) which provides that, where a person is barred from acting as director, officer, investment adviser or principal underwriter because of an injunction or other reasons there specified, the Commission, on application, may grant appropriate relief, if it appears that as to such person the bar is "unduly or disproportionately severe" and that the granting of such application is "not against the public interest or protection of investors."

> cation, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

This Rule prohibits the solicitation of proxies by means of proxy material which is false or misleading or which omits to state any material facts necessary to make any statement in the proxy material not false or misleading. It also provides that such omission is in contravention of the Rule, if the omitted material is necessary to "correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading." As a second cause of action the Commission's complaint alleges a violation of this Rule (R. 11–14).

In substance, the Commission's amended complaint alleges that the proxy material prepared and used by ISI in the solicitation of proxies for investor approval of new investment advisory and principal underwriting contracts, was false and misleading in that it failed to disclose material facts, including the price received by the director-defendants for their ISI stock, the net asset value of the ISI stock, and the pecuniary benefits the director-defendants had realized as a consequence of the sale of stock control

(R. 13, 47). Also, the ISI proxy letter sent to investors in the Trust Fund stated that the change in control of ISI may have "the technical effect" of terminating ISI's investment advisory and principal underwriting contracts with the Trust Fund (R. 21). Since such change in control has also resulted in subjecting ISI and the director-defendants to the sanctions of Section 36, it was false and misleading to characterize such effect as merely "technical" (R. 12–13).

The court below did not reach this question, since the alleged proxy violation was expressly dependent upon the cause of action under Section 36 (R. 11), and the court held that no such cause of action was alleged as a matter of law. The court said: "While the complaint sets forth two causes of action, it is clear, and indeed it is admitted, that the second cause of action stands or falls upon the validity of the first. Consequently, it is unnecessary to discuss the second cause of action" (R. 150). We assume that this Court will determine the legal sufficiency of the cause of action alleged under Rule X–14A–9, if, as we contend, a cause of action under Section 36 is properly alleged. Accordingly, we discuss the issues here.

In support of their motion to dismiss the second cause of action, appellees made two arguments; (1) that the staff of the Commission had reviewed the proxy material and did not suggest that the alleged omissions be supplied; (2) that the proxy material met the requirements of the Rule. Both contentions, we submit, are without merit.

In its letter of comment on ISI's preliminary proxy material, dated July 10, 1956, the staff of the Commission suggested certain changes (R. 103–104), which were complied with. But this letter also stated (R. 104):

> We understand that our Division of Corporate Regulation has raised certain questions regarding the assignment of the Investment Advisory and Underwriting Contracts.

The defendants contended that this reference was only to the applicability of Section 36 and not to the adequacy of the proxy material, as though the two matters were unrelated. It is clear, however, that such was not the intent of the letter.

That letter merely indicated certain changes and revisions which could at that time be definitively suggested. Obviously, such disclosures as might be required in light of the applicability of Section 36 could not then be made, since the problem raised under that Section had not been definitively resolved by the Commission and its staff (R. 138–140). The record also shows that the adequacy of the proxy material in the light of Section 36 was still an open question, and that appellees so understood (R. 97–102). In a telephone conversation with a member of the Commission's staff five days before the proxy material was mailed by ISI to investors, Mr. Haight, secretary and director of ISI and one of the appellees herein, was specifically requested to furnish certain information so that the Commission might resolve the problem under Section 36. In the course of that conversation Mr. Haight inquired whether the proxy solicitation mate-

rial could be mailed out, and he was advised (R. 100–101):

> * * * that the matter of mailing the proxy material should be considered in the light of the Section 36 problem we had raised and that if there was a mailing before we had studied the matter, they would have to assume the risk that the Commission may resolve the problem adversely to them.

In his affidavit Mr. Haight states in response (R. 76): "Never, by letter or otherwise, did anyone in the Securities and Exchange Commission suggest or request any further or different changes or revisions or intimate that any should be made." This does not controvert or deny the advice given to him by the Commission's staff.

In any event it is evident that in order to resolve in its own mind the applicability of Section 36, the Commission needed certain information, including the critical fact of price paid for the ISI stock. This and other information did not reach the Commission until about eight days after the definitive proxy material had been mailed to investors in the Trust Fund (R. 101–102, 105–106, 122).

The purpose of requiring the filing of preliminary proxy material under Rule X–14A–6 is to enable the Commission to aid the companies and their managements, and to assure, as far as possible, full compliance with the intent and purpose of the Proxy Rules. Under the view urged by appellees this procedure would not be feasible, if the Commission were estopped from enforcing the Proxy Rules because it

failed to comment on the preliminary material through lack of information or otherwise. The absence of comment will be a certainty where, as in the instant case, the relevant information is within the possession of the persons making the solicitation but not known to the staff or the Commission.

The substantive question here involved is whether the omitted information was material and whether failure to disclose it constitutes a violation of the Proxy Rules. The purpose of the Proxy Rules is to require full disclosure of material information as well as the elimination of untrue and misleading statements, so that the security holder whose proxy is solicited may be better able to exercise his informed judgment in casting his vote. The court said in *SEC* v. *Okin,* 58 F. Supp. 20, 23 (S. D. N. Y. 1944):

> The Acts in question were clearly adopted by Congress to protect the interest of investors in securities, to require the giving to them of information necessary to appraise the financial position of such securities, and to furnish them with information which would enable them to act intelligently in the giving of proxies and in other transactions in the companies in which they held securities.[84]

In terms of these standards it is clear that the investors in the Trust Fund were not adequately apprised of the facts so as to be able to exercise an informed judgment. Their proxies were solicited by ISI and its management, *inter alia,* for the purpose of securing their consent to new investment advisory

[84] See also, Loss, *Securities Regulation* (1951), pp. 523ff.

and principal underwriting contracts between ISI and the Trust Fund, as a consequence of the transfer of stock control of ISI. To that end it was not enough merely to advise the investors in general terms that there was such transfer. ISI and its management, as fiduciaries of the Trust Fund, should have also advised investors of the relevant details regarding the stock transactions which led to the shift in control of ISI and the financial benefits which accrued therefrom to the director-defendants. When asked for their consent, investors are entitled to appraise whether the recommendations of the management are disinterested or moved by considerations of personal gain. *Cf. Dunnett* v. *Arn,* 71 F. 2d 912, 919–920 (C. A. 10, 1934). Nor may it be represented to them that the transfer of control had the "technical effect" of terminating ISI's contracts when, as we contend, a gross abuse of trust was also involved as a result of such transfer.

Appellees also urged that a proxy statement cannot be misleading unless it is related to some affirmative statement or representation already contained in the proxy statement. This is without any merit. Failure to disclose material information is as much an abuse of the proxy machinery as an outright falsehood or an ambiguous statement deliberately contrived. The effect upon public investors is the same. In construing language under another statute almost identical in wording with that provided in Rule X–14A–9, the court said in *Hughes* v. *SEC,* 174 F. 2d 969, 976 (C. A. D. C. 1949):

> These quoted words as they appear in the statute can only mean that Congress forbid not only the telling of purposeful falsity but also the telling of half-truths and the failure to tell the "whole truth." These statutory words were obviously designed to protect the investing public as a whole whether the individual investors be suspicious or unsuspecting.[85]

We recognize that appellees disagree with the Commission's construction of Section 36 and related provisions of the Act, and the dilemma this posed for ISI and its management when soliciting proxies in advance of a resolution of the relevant problems under Section 36. But that is a risk which they, not the public investors, must assume. At the very least ISI might have disclosed the relevant information, including the questions raised under Section 36, with an appropriate opinion thereon by its own counsel. The assumption that in soliciting proxies ISI and its directors can limit their disclosures solely in the light of their own conclusion as to the scope of Section 36, seems to us fallacious.

We are advised that at the adjourned meeting of investors in the Trust Fund, held on September 14, 1956, the proxies were exercised in favor of new investment advisory and principal underwriting contracts between ISI and the Trust Fund (R. 141). But that does not preclude the granting of appropriate relief, if, as we contend, the proxies were unlawfully solicited. See *May* v. *SEC,* 134 F. Supp. 247 (S. D. N. Y. 1955), affirmed on appeal 229 F. 2d 123

[85] *Cf. Equitable Life Ins. Co.* v. *Halsey, Stuart & Co.*, 312 U. S. 410, 425–426 (1941).

(C. A. 2, 1956). The Commission's motion for a preliminary injunction was withdrawn upon the understanding, as set forth in the Second Interlocutory Order, that it was without prejudice to the power of the court to grant appropriate relief, "including any action with respect to the Investment Advisory and Principal Underwriting Contracts, whether or not approved by Investors in the Trust Fund, if it is determined in a final decree that plaintiff is entitled to judgment" (R. 95).

## CONCLUSION AND RELIEF SOUGHT

The order of the court below should be reversed and the case remanded to the court below. More particularly, we respectfully urge this Court to make the following determinations:

*First.* The order of the court below dismissing the Commission's amended complaint should be reversed and the amended complaint reinstated.

*Second.* In the interest of expedition a determination should be made, if this Court deems it appropriate, that the amended complaint alleges a violation of Rule X–14A–9 of the Commission's Proxy Rules.

*Third.* The order of the court below dismissed the complaint and also dissolved the Second Interlocutory Order of August 30, 1956 (R. 151–152). The Commission appealed from both parts of the order (R. 152-153). The Second Interlocutory Order (R. 93–95), summarized pp. 14–15, *supra,* was entered on stipulation of the parties (R. 95). Pursuant thereto appellees undertook to refrain from taking certain actions pending a final determination of the case. We respectfully

suggest that on remand the Second Interlocutory Order be reinstated.

Respectfully submitted.

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JULY 1957.

## APPENDIX A

The following are pertinent provisions of the Investment Company Act of 1940, 15 U. S. C. 80 (a)–1, *et seq.:*

SEC. 1. (a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, amount other things—

> (1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

* * * * *

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * * * *

> (4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment



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companies are managed by irresponsible persons;

* * * * *

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

* * * * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(2) "Affiliated company" means a company which is an affiliated person.

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other

person is an unincorporated investment company not having a board of directors, the depositor thereof.

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

*     *     *     *     *

(12) "Director" means any director of a corporation of any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust.

*     *     *     *     *

(19) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A); but does not include (i) a person whose advice is

furnished solely through uniform publications distributed to subscribers thereto, (ii) a person who furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities, (iii) a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions, (iv) any person the character and amount of whose compensation for such services must be approved by a court, or (v) such other persons as the Commission may by rules and regulations or order determine not to be within the intent of this definition.

* * * * *

(27) "Person" means a natural person or a company.

(28) "Principal underwriter" of or for any investment company other than a closed-end company, or of any security issued by such a company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company.

* * * * *

(31) "Redeemable security" means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approxi-

mately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

*    *    *    *    *

CLASSIFICATION OF INVESTMENT COMPANIES

SEC. 4. For the purposes of this title, investment companies are divided into three principal classes, defined as follows:

(1) "Face-amount certificate company" means an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which has been engaged in such business and has any such certificate outstanding.

(2) "Unit investment trust" means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust.

(3) "Management company" means any investment company other than a face-amount certificate company or a unit investment trust.

SUBCLASSIFICATION OF MANAGEMENT COMPANIES

SEC. 5. (a) For the purposes of this title, management companies are divided into open-end and closed-end companies, defined as follows:

(1) "Open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Close-end company" means any management company other than an open-end company.

(b) Management companies are further divided into diversified companies and non-diversified companies, defined as follows:

(1) "Diversified company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.

*　　*　　*　　*　　*

INELIGIBILITY OF CERTAIN AFFILIATED PERSONS AND UNDERWRITERS

Sec. 9. (a) It shall be unlawful for any of the following persons to serve or act in the capacity of officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company:

(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company;

(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment

adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or

(3) a company any affiliated person of which is ineligible, by reason of paragraph (1) or (2), to serve or act in the foregoing capacities.

* * * * *

(b) Any person who is ineligible, by reason of subsection (a), to serve or act in the capacities enumerated in that subsection, may file with the Commission an application for an exemption from the provisions of that subsection. The Commission shall by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of subsection (a), as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application.

AFFILIATIONS OF DIRECTORS

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(b) After one year from the effective date of this title, no registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a

majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or affiliated persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 12 (d) (3) (A) and (B).

* * * * *

(h) In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

* * * * *

(2) the provisions of subsections (b) and (c), as modified by subsection (e), shall apply to the board of directors of the depositor and of every investment adviser of such company;

* * * * *

INVESTMENT ADVISORY AND UNDERWRITING CONTRACTS

Sec. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to

serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

(b) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract, unless in effect prior to March 15, 1940—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

*Provided, however,* That the limitation to March 15, 1945, shall not apply in either case if prior to that date such contract is renewed in such form that it complies with the requirements of subsection (a) or (b) of this section, as the case may be, and is approved in the manner required by this section in respect of a contract of the same character made after March 15, 1940.

* * * * *

TRANSACTIONS OF CERTAIN AFFILIATED PERSONS AND UNDERWRITERS

SEC. 17. (a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12 (d) (3) (A) and (B)), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless

the borrower is controlled by the lender) except as permitted in section 21 (b).

(b) Notwithstanding subsection (a), any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of that subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this title; and

(3) the proposed transaction is consistent with the general purposes of this title.

* * * * *

PROXIES; VOTING TRUSTS; CIRCULAR OWNERSHIP

SEC. 20. (a) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

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PLANS OF REORGANIZATION

SEC. 25. (a) Any person who, by use of the mails or any means or instrumentality of interstate commerce

or otherwise, solicits or permits the use of his name to solicit any proxy, consent, authorization, power of attorney, ratification, deposit, or dissent in respect of any plan of reorganization of any registered investment company shall file with, or mail to, the Commission for its information within twenty-four hours after the commencement of any such solicitation, a copy of such plan and any deposit agreement relating thereto and of any proxy, consent, authorization, power of attorney, ratification, instrument of deposit, or instrument of dissent in respect thereto, if or to the extent that such documents shall not already have been filed with the Commission.

(b) The Commission is authorized, if so requested, prior to any solicitation of security holders with respect to any plan of reorganization, by any registered investment company which is, or any of the securities of which are, the subject of or is a participant in any such plan, or if so requested by the holders of 25 per centum of any class of its outstanding securities, to render an advisory report in respect of the fairness of any such plan and its effect upon any class or classes of security holders. In such event any registered investment company, in respect of which the Commission shall have rendered any such advisory report, shall mail promptly a copy of such advisory report to all its security holders affected by any such plan: *Provided,* That such advisory report shall have been received by it at least forty-eight hours (not including Sundays and holidays) before final action is taken in relation to such plan at any meeting of security holders called to act in relation thereto, or any adjournment of any such meeting, or if no meeting be called, then prior to the final date of acceptance of such plan by security holders. In respect of securities not registered as to ownership, in lieu of mailing a

copy of such advisory report, such registered company shall publish promptly a statement of the existence of such advisory report in a newspaper of general circulation in its principal place of business and shall make available copies of such advisory report upon request. Notwithstanding the provision of this section the Commission shall not render such advisory report although so requested by any such investment company or such security holders if the fairness or feasibility of said plan is in issue in any proceeding pending in any court of competent jurisdiction unless such plan is submitted to the Commission for that purpose by such court.

(c) Any district court of the United States in the State of incorporation of a registered investment company or any such court for the district in which such company maintains its principal place of business is authorized to enjoin the consummation of any plan of reorganization of such registered investment company upon proceedings instituted by the Commission (which is authorized so to proceed upon behalf of security holders of such registered company, or any class thereof), if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan.

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INJUNCTIONS AGAINST GROSS ABUSE

SEC. 36. The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years

of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

LARCENY AND EMBEZZLEMENT

SEC. 37. Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

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LIABILITY OF CONTROLLING PERSONS; PREVENTING COMPLIANCE WITH TITLE

SEC. 48. (a) It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the

provisions of this title or any rule, regulation, or order thereunder.

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RULES AND REGULATIONS

Rule N–20A–1 promulgated pursuant to Section 20 (a) of the Investment Company Act of 1940 provides in pertinent part:

> (a) Subject to paragraph (b), no person shall solicit or permit the use of his name to solicit any proxy, consent or authorization in respect of any security of which a registered investment company is the issuer except upon compliance with the provisions of all rules and regulations adopted pursuant to the provisions of Section 14 (a) of the Securities Exchange Act of 1934 that would be applicable to such solicitation if such solicitation were in respect of a security registered on a national securities exchange.

Regulation X–14 promulgated by the Commission pursuant to Section 14 (a) of the Securities Exchange Act of 1934 provides in pertinent part as follows:

> RULE X–14A–9. FALSE OR MISLEADING STATEMENTS
>
> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements herein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

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